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# Advisory Committee on Tax Exempt and Government Entities (ACT)

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## Report of Recommendations



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**Advisory Committee on Tax Exempt and Government Entities (ACT)  
Public Meeting  
1111 Constitution Ave, NW  
Room 3313  
Washington, DC 20224**

**June 7, 2006**

**Meeting Begins at 9:00 a.m.**

**AGENDA**

Meet and Greet (8:30 a.m. – 9:00 a.m.)

Welcome and Opening Remarks

- Steven T. Miller, Commissioner, Tax Exempt and Government Entities
- Steven J. Pyrek, Designated Federal Official of the ACT
- Robert E. Donovan, Chair of the ACT

***Policies and Guidelines for Form 990 Revision***

Suzanne Ross McDowell, Project Leader

***Document Compliance Program for 403(b) Arrangements***

Michael P. Coyne, Project Leader

***Public Employers' Toolkit for Preparing Payrolls***

Nicholas C. Merrill, Jr., Project Leader

***Effect of IRS Audit Information on Tax Exempt Bond Market***

Maxwell D. Solet, Project Leader

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## GENERAL REPORT OF THE ACT

At this fifth meeting of the Advisory Committee on Tax Exempt and Government Entities (the "ACT"), the ACT members appreciate the opportunity to present our report to the Internal Revenue Service and the public on specific topics of interest involving the Tax Exempt and Government Entities Division of the Service and the stakeholders with whom it interacts. This year there are four reports containing recommendations to the Service in the areas of exempt organizations, employee plans, federal, state and local governments and tax exempt bonds. Specifically the reports are:

- Policies and Guidelines for Form 990 Revision
- Document Compliance Program for 403(b) Arrangements
- Public Employers' Toolkit for Preparing Payrolls
- Effect of IRS Audit Information on Tax Exempt Bond Market.

In reviewing the recommendations presented in each of the reports, it is important to recognize that the value of the recommendations is not based on the ease in which they can be implemented, but rather on the dialogue between the ACT, the Service and the various stakeholder groups about issues of importance to each, on which the recommendations were developed.

As has taken place with the recommendations from previous ACT reports, some have been implemented while others continue to be evaluated and discussed in hopes of being implemented. The same will occur for the recommendations contained in this year's reports some can be implemented immediately while others may take years but the dialogue between the parties will benefit all involved.

It is also important to recognize the role of the ACT members in facilitating communication between the various stakeholder groups and the Service. The amount of time that the members dedicate to the ACT and in the preparation of the reports goes well beyond the meetings in Washington, DC. The members take every opportunity to seek out issues and information from the stakeholders to ensure they are presented to the Service. It is the dedication of the ACT members that has made and will continue to make the ACT a vital resource for the Service and stakeholder groups.

This year the ACT saw a change in the makeup of its membership with the Service expanding the Committee beginning after June 2006 from 18 to 21 members by adding an additional member in the areas of Indian tribal government, tax exempt bonds, and federal, state and local governments. Also as in the past several members have completed their service on the ACT and the continuing members of the ACT and I would like to thank them for their dedicated service and contribution to the ACT and for their friendship.

Specifically they are:

- Ann Western Bittman, American Forest and Paper Association, Washington, D.C.
- Michael P. Coyne, Waldheger & Coyne, Westlake, Ohio
- Douglas Kant, Fidelity Investment, Boston, Mass.
- Robert L. Gips, Drummond, Woodsum & MacMahon, Portland, Me.
- George Vera, The David and Lucile Packard Foundation, Los Altos, Calif.

The ACT would like to thank Commissioner Mark W. Everson for his interest in the ACT and its activity. We would also like to thank TE/GE Commissioner Steven T. Miller and his Directors, Carol Gold, Preston Butcher, and Lois Lerner, as well as Christie Jacobs, Cliff Gannett, Sunita Lough and the other Service staff for their assistance and guidance. In addition, the ACT would like to thank Martha Sullivan and Mark Scott for their assistance while they were with the Service.

The ACT would like both to thank Sarah Hall Ingram for her support while serving as the Deputy Commissioner of TE/GE and to congratulate her on her new role as Chief of Appeals. Your presence will be missed.

Finally the ACT would like to thank Steven Pyrek, the ACT's Designated Federal Official, whose management and organizational skills assist the ACT greatly in its work.

To continue to be effective, the ACT depends on the dedication of its members and communication with the Service and stakeholders. The result, it is hoped, will be improved compliance and enforcement in the sector.

Robert E. Donovan  
Chairman

**ADVISORY COMMITTEE  
ON TAX EXEMPT AND GOVERNMENT ENTITIES**

**2005-2006**

**Member Biographies**

**EMPLOYEE PLANS**

- **Michael P. Coyne**, Westlake, Ohio

Mr. Coyne is an attorney-at-law with Waldheger-Coyne. His practice focuses on tax, corporate and employee benefit issues of small employers and closely held businesses, with special emphasis on clients involved in healthcare. He presently represents approximately 350 qualified plans. Mr. Coyne is a fellow of the American College of Employee Benefits Counsel. He holds a Juris Doctor in Law from Case Western Reserve University School of Law.

- **Douglas Kant**, Waban, Mass.

Mr. Kant is Senior Vice President and Deputy General Counsel at Fidelity Investments, where he works primarily with institutional retirement and employee benefits business units. He has a 25-year background in tax, ERISA and compliance aspects of qualified and non-qualified retirement plans of both for-profit and tax exempt sectors. Mr. Kant is on the Board of Directors of the American Benefits Council and holds a Juris Doctor in Law from the Boston University School of Law and an L.L.M. in taxation from the B.U. Law Graduate Tax Program.

- **Charles M. Lax**, Southfield, Mich.

Mr. Lax is a partner and chairman of the Employee Benefits Group at his law firm, Maddin, Hauser, Wartell, Roth & Heller, P.C. His responsibility includes the representation of approximately 350 qualified retirement plans of all types and sizes. He authored numerous articles appearing in legal and public accounting journals and lectured extensively on qualified retirement plans and other tax topics. Mr. Lax received his Juris Doctor from the University of Michigan. He presently serves as the Chairman of the Tax Section of the State Bar of Michigan.

- **Charles F. Plenge**, Dallas, Tex.

Mr. Plenge is a partner in Hayes and Boone, LLP and is Chair of its Employee Benefits/Executive Compensation Practice Group. His practice primarily involves a broad range of employee benefits and executive compensation matters on behalf of employers. Mr. Plenge is a Charter Fellow of the

American College of Employee Benefits Counsel and holds his Juris Doctor in Law from Southern Methodist University Dedman School of Law.

- **Daniel J. Schwartz**, St. Louis, Mo.

Mr. Schwartz is a shareholder in the St. Louis law firm of Greensfelder, Hemker & Gale, P.C. His practice encompasses all aspects of employee benefits and executive compensation law, with a special emphasis on employee benefits issues for tax-exempt organizations. Mr. Schwartz is a Charter Fellow of the American College of Employee Benefits Counsel. He received his JD from the University of Missouri-Kansas City.

- **Michael S. Sirkin**, New York

Mr. Sirkin is a senior partner in the Employee Benefits and Executive Compensation Group in his firm, Proskauer Rose LLP. He has practiced in the employee benefits area since 1972 and has been heavily involved with all aspects of employee benefits, including extensive experience in qualified plans, 403(b) plans and nonqualified plans. Mr. Sirkin is a graduate of Columbia Law School.

## **EXEMPT ORGANIZATIONS**

- **Betsy Buchalter Adler**, San Francisco

Ms. Adler is a member of the law firm of Silk, Adler and Colvin, which specializes in the law of nonprofit and tax-exempt organizations. In that capacity she provides legal advice and counsel to grant-making charities, operating charities, educational and religious institutions, trade associations, and individual and corporate philanthropists. Ms. Adler is the immediate past chair of the Exempt Organizations Committee of the Tax Section of the American Bar Association and a well-known author and lecturer in the tax-exempt field. She received her B.A. from the University of California at Santa Cruz and her J.D. from Boalt Hall School of Law, University of California at Berkeley.

- **Ann Western Bittman**, Washington, D.C.

Ms. Bittman is Vice President, Finance & Administration and Chief Financial Officer of the American Forest and Paper Association in Washington, D.C. and a member of the American Society of Association Executives (ASAE), where she has served in numerous leadership positions. Ms. Bittman has over 16 years of experience in not-for-profit organizations and is a Certified Public Accountant (CPA), a Certified Financial Planner (CFP) and a Certified Association Executive (CAE). She holds a Bachelors degree in Business Administration from Georgetown University.



- **Sean Delany**, New York

Mr. Delany is the Executive Director of Lawyers Alliance for New York, Inc., an organization that provides non-litigation legal assistance to nonprofits and community development organizations in New York City. His organization provides services dedicated to improving the accountability and efficiency of small tax-exempt organizations, and includes counseling on their ongoing compliance with federal and state regulatory obligations. He has also served as Assistant Attorney General in Charge of the Charities Bureau in the New York Attorney General's office.

- **Julie L. Floch**, New York

Ms. Floch is the Director of Not-for-Profit Services at Eisner LLP, and is the partner responsible for coordinating the planning and administration of engagements in the firm's not-for-profit practice. She is an adjunct professor of auditing at Baruch College/CUNY and teaches not-for-profit management at the New School University. A graduate of the State University of New York at Binghamton, with graduate studies at Baruch College/CUNY, Ms. Floch serves on the influential Not-for-Profit Organizations Expert Panel of the American Institute of CPAs and is currently a member of the New York State Society of CPAs' committee on not-for-profit organizations (which she formerly chaired) and its committee on tax-exempt entities.

- **Suzanne Ross McDowell**, Washington, D.C.

Ms. McDowell is a partner at the law firm of Steptoe & Johnson LLP, where her practice focuses primarily on tax-exempt organizations. She has 25 years experience working with nonprofit organizations. Prior to joining Steptoe & Johnson, she was Senior Vice President and Deputy General Counsel at the National Geographic Society, Washington, DC. She also served as Associate Tax Legislative Counsel at the U.S. Department of the Treasury in the mid-1980s. Ms. McDowell is the Chair of the D.C. Bar Tax Section, a member of the Legal Section Council of the American Society of Association Executives, and active in the ABA Tax Section. She received her A.B. from Smith College and her J.D., *magna cum laude*, from the George Washington University National Law Center.

- **George A. Vera**, Los Altos, Calif.

Mr. Vera is a CPA and the Vice President and Chief Financial Officer of the Packard Foundation, one of the largest private foundations in the nation. He is responsible for the finance and administration functions of the foundation, including investments, finance and accounting, information technology, facilities and grants management. He holds a Masters of Business Administration from Harvard University.

## **GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS**

- **Nicholas C. Merrill, Jr.**, Springfield, Ill.

Mr. Merrill is the manager of the accounting division for the State Employees' Retirement System of Illinois, a large statewide Public Employees' Retirement System. He is a certified public accountant and previously worked for a national public accounting firm where he specialized in governmental audits. He has served as President of the National Conference of State Social Security Administrators (NCSSSA), as well as in other roles within that organization. Mr. Merrill is also active in the Government Finance Officers Association.

- **Julian Regan**, Marlborough, Mass.

Until April 2006, Mr. Regan was Executive Director of the New York State Deferred Compensation Board, which oversees the State's 159,000-member, \$7.1 billion Deferred Compensation Plan and performs state regulatory duties that relate to 250 independently operated section 457 plans. He served for a number of years in the financial operations arena of the Massachusetts Bay Transportation Authority as well as in operations and audit capacities for private sector firms that specialize in delivering services to large Tax-Exempt Entities. He is a member of the New York State Government Finance Officers Association (NYSGFOA). Mr. Regan is now a Vice President for Fidelity Employer Services Company, where he works primarily with institutional retirement and employee benefits business units.

## **GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS**

- **Robert L Gips**, Portland, Me.

Mr. Gips is a practicing attorney, of counsel to Drummond, Woodsum & McMahon, specializing in the representation of Indian tribal governments and businesses. A major focus of his practice is tribal economic development. He has negotiated a number of the largest and most complex business and financing transactions done in Indian Country, including tribal acquisitions of operating businesses and creation of new tribal enterprises and joint ventures. Mr. Gips received his undergraduate degree from Harvard College and has a joint degree in law and business management from Yale Law School and Yale School of Management.

- **Lenor A. Scheffler**, Minneapolis, Minn.

Ms. Scheffler, a partner with Best & Flanagan, heads the firm's Native American Law Practice Group which represents a number of Indian tribes on tax, finance, business, and government matters. She has previously served as General Counsel and as Vice President of Corporate and Legal Affairs for tribes in Minnesota. She is currently the Chief Judge of the Upper Sioux Community Tribal Court. Ms. Scheffler received her Juris Doctor from the William Mitchell College of Law.

## **GOVERNMENT ENTITIES: TAX EXEMPT BONDS**

- **Robert Donovan**, Providence, R.I.

Mr. Donovan is Executive Director of the Rhode Island Health and Educational Building Corporation. He is responsible for the operation of the state designated issuer of tax-exempt bond debt on behalf of private non-profit health care and educational institutions. He also serves on a number of boards and committees relating to tax-exempt bonds. Mr. Donovan holds a Certificate of Advance Graduate Studies in Finance, as well as an MBA from Bryant College.

- **Maxwell D. Solet**, Boston

Mr. Solet is a member of the law firm of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., where he has principal tax responsibility in connection with the firm's role as bond counsel, underwriter's counsel and purchaser's counsel on state or local bond issues. These include bonds of large general obligation issuers, specialized revenue bond issuers, housing finance agencies, student loan agencies, and conduit issuers of bonds to finance healthcare and education facilities and solid waste disposal facilities. He is a former chair of the Tax Section of the Boston Bar Association and has been a member of the steering committee of the annual Bond Attorneys Workshop. Mr. Solet received a Bachelor's degree from Harvard College and a Juris Doctor degree from Harvard Law School.

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**Advisory Committee on  
Tax Exempt and Government Entities  
(ACT)**

**POLICIES AND GUIDELINES FOR  
FORM 990 REVISION**

**Julie L. Floch, Project Leader  
Suzanne Ross McDowell, Project Leader  
Betsy Buchalter Adler  
Ann Western Bittman  
Sean Delany  
George A. Vera**

June 7, 2006

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**TABLE OF CONTENTS**

	Page
I. Executive Summary.....	1
II. Statement of Problem and Project Objectives .....	2
A. Problem.....	2
B. Objectives .....	2
III. Process.....	3
IV. Background.....	6
A. History of Form 990.....	6
1. Tax Exemption.....	6
2. Annual Filing Requirements .....	6
3. Public Disclosure .....	7
4. Development of Form 990 from 1941 to the Present.....	7
B. Comments on the Current Form 990.....	10
1. Announcement 2002-87 .....	10
2. Senate Finance Committee .....	12
3. National Center for Charitable Statistics.....	12
C. Current Uses of Form 990.....	14
D. Challenges and Limitations .....	17
1. Diversity of the Nonprofit Sector.....	17
2. Form 990 as a Tool to Detect Diversion of Assets .....	18
3. Incremental Implementation .....	20
4. Challenges and Opportunities of Electronic Filing .....	21
V. Recommendations.....	23
1. Form 990 should be designed primarily to assess whether the filer is complying with federal tax requirements. ....	23
2. IRS should continue to accommodate the needs of the states as long as they do not adversely affect the IRS’s primary mission or unduly burden filers.....	23
3. Form 990 and its instructions should be as understandable to a person unschooled in the law of tax-exempt organizations as possible without compromising its primary purpose. ....	24

4.	Form 990 should consist of a core form with schedules organized by topic and type of organization .....	24
5.	Questions on Form 990 should be formulated to obtain evidence or facts which will reveal whether the filer has complied with federal tax law.....	25
6.	Statutory limits on mandatory electronic filing should be removed and mandatory electronic filing should be phased in. ....	27
7.	Form 990 should be redesigned in its entirety and implemented as quickly as possible. ....	27



## I. Executive Summary

Since 1942, tax-exempt organizations have been required to file an annual information return. Currently, the filing is made on Form 990. Over the last 50 years, three important changes have taken place that affect Form 990. First, the form has grown in an incremental fashion from a two-page form to a 15-page form. Because of the incremental growth and various practical considerations in form design, the result of this growth is a form that lacks internal coherence and is difficult for both filers and users to understand. Second, while the form was designed initially by the Internal Revenue Service (the “Service” or “IRS”) to meet its own tax administration needs, it is now also used by other parties, including state tax authorities and charities’ bureaus, the public, the press and researchers. Third, electronic filing was mandated for a limited number of exempt organizations in 2006 and electronic filing is increasingly available on a voluntary basis as well.

Fueled in part by the changes above, in recent years, there has been growing dissatisfaction with Form 990, leading to suggestions for change from various stakeholders. The Service shares this dissatisfaction and is actively engaged in a revision of Form 990, but the revision project is extremely challenging for a number of reasons. Because users of Form 990 now include a diverse group with different objectives, there are competing interests and priorities. Inevitably, satisfaction of the needs of one group of users may compromise the Service’s ability to meet its own or the needs of another group. Additionally, the needs of the Service as well as other users must be balanced updating and processing the form. There is also a tension between the Service’s need to be nimble in responding to new enforcement concerns and the desire of filers as well as the Service and other users for stability in the form from year to year. The introduction and anticipated growth of electronic filing introduces new considerations for the design of the form. Finally, budgetary considerations present challenging constraints on implementing a completely redesigned form.

This project grew out of the ACT’s conviction that a successful redesign of Form 990 must be preceded by an understanding of the history of Form 990, an analysis and prioritization of the competing interests and needs of Form 990 users, identification of the challenges and limitations affecting a redesign project and, finally, establishment of policies and guidelines to serve as a framework for decisionmaking.

This report explains the process that the ACT followed; describes the historical development of Form 990; discusses current uses of Form 990; and identifies the challenges and limitations in redesigning Form 990. Finally, this report makes the following recommendations:

1. Form 990 should be designed primarily to assess whether the filer is complying with federal tax requirements.

2. IRS should continue to accommodate the needs of the states as long as they do not adversely affect the IRS's primary mission or unduly burden filers.
3. Form 990 and its instructions should be as understandable to a person unschooled in the law of tax-exempt organizations as possible without compromising its primary purpose.
4. Form 990 should consist of a core form with schedules organized by topic and type of organization.
5. Questions on Form 990 should be formulated to obtain evidence or facts which will reveal whether the filer has complied with federal tax law.
6. Statutory limits on mandatory electronic filing should be removed and mandatory electronic filing should be phased in.
7. Form 990 should be redesigned in its entirety and implemented as quickly as possible.

## **II. Statement of Problem and Project Objectives**

### **A. Problem**

Over the last 50 years, three important changes have taken place that affect Form 990. First, Form 990 has grown from two pages to 15 pages. The growth has been incremental with additional questions being added to meet particular needs. Form 990 has now reached a point where it is long, poorly organized and difficult for both filers and users to understand. Second, while the Service designed the form for tax administration purposes, it is now used by a wide audience that includes state tax authorities and charities bureaus, the public, the press, and researchers. As users of Form 990 have come to expect it to be all things to all people, they have -- not surprisingly -- been disappointed. Third, the Service is now moving toward electronic filing. Some exempt organizations are required to file electronically now, and it is expected and desired that an increasing number will file electronically in the future. The advent of electronic filing adds new considerations to the use of Form 990. The Service shares these concerns and is actively working on a revision of Form 990.

### **B. Objectives**

The ACT believes that successful revision of Form 990 depends upon establishing clear policies and guidelines to serve as a framework for evaluating

the current form and any proposed revisions. This framework must acknowledge that there are competing interests that seek to be served by the form, that the form is filed by a diverse group of organizations, and that the Service has limited resources to devote to the redesign of Form 990 and the implementation of a redesigned form. A useful framework must clearly identify competing interests and prioritize them. It must also recognize the limited resources of filers as well as users of Form 990. The objective of this project is to provide a framework for evaluating the efficacy of Form 990 and to suggest policies and guidelines for evaluation and revision of Form 990.

### **III. Process**

The ACT obtained information about the purposes and current uses of Form 990 from the perspective of the Exempt Organizations (“EO”) Division of the Service, the states, the general public, media, donors, legislators and regulators. The ACT obtained this information through a series of interviews with IRS staff, individuals in the private sector, state regulators, and from a review of public and private reports, articles, papers and studies.

Our interviews covered the history and development of the current form; the information requested on the form and the format in which it is requested; changes that could improve the form; specific topics or common threads that may need to be clarified on the form; different approaches to design of the form; the effect of e-filing on the purposes and uses of the form; and the relationship between the Service’s needs and the needs of state charity regulators.

From interviews with EO staff, the ACT sought to obtain a detailed understanding of the relative priority of the various purposes of the form from the Service’s perspective. ACT asked each individual to explain the existing procedures for processing and using Form 990 data, to assess the effectiveness of these processes and to make suggestions for improvements. In the fall, the ACT interviewed the following staff from the Tax Exempt and Government Entities (“TE/GE”) Division of the Service: Martha Sullivan, then Director, EO Division; Steven Miller, Commissioner, TE/GE Division; Sarah Hall Ingram, then Deputy Commissioner, TE/GE Division; Mike Seto, Acting Manager, EO; Cheryl Chasin, Subject Matter Expert, EO Electronic Initiatives; Midori Morgan-Gaide, Manager, EO Electronic Initiatives; Leonard Avant, Group Manager, EO Examinations; Marvin Friedlander, Manager, Technical, EO Rulings and Agreements; Lois Lerner, Director, EO Division; Janet Gitterman, Sr. Tax Law Specialist (Deputy Form 990 Project Leader); Terri Harris, Attorney, Chief Counsel’s Office; and Elizabeth Goff, Tax Law Specialist.

On December 13, 2005, the National Center on Philanthropy and the Law at New York University convened a “mini conference,” at the suggestion of the ACT, to explore the conceptual and practical issues surrounding the form. The conference was led by Professor Harvey P. Dale, University Professor of

Philanthropy and the Law and Director Center for Philanthropy and the Law, New York University School of Law and Jill S. Manny, Adjunct Professor of Law and Executive Director, Center for Philanthropy and the Law, New York University School of Law. The seventeen attendees included five ACT members, one former ACT member, four EO staff and representatives from private industry, academia, state charity bureaus and other users of Form 990 information. The conference participants focused on three current purposes, uses and audiences of Form 990 -- the federal tax system, the states, and the public -- and discussed whether each one was a priority for Form 990 and improvements that would better serve each purpose. Participants also discussed approaches to design of the form.

At the January 2006 ACT meeting, the ACT again interviewed various EO Division personnel, including: Marsha Ramirez, Director of EO Examinations; Joe Urban, Acting Director, EO Rulings & Agreements; Rob Choi, Executive Assistant to the Director, EO Division; Jeanne Callahan, Executive Assistant to the Director, EO Division; and Roberta Zarin, Director, Customer Education and Outreach, EO Division.

The ACT interviewed state charity regulators to solicit information on the states' needs; the relative importance of those needs; and benefits the Service and the states obtain through mutual cooperation. ACT members asked how the states and the Service currently work together and how they could improve accountability, compliance and transparency by changing and/or enhancing the form. The following regulators were interviewed: Terry Knowles, Registrar, Charitable Trusts Unit, New Hampshire and Chair, National Association of State Charities Officials ("NASCO"); Karin Goldman, Assistant Attorney General, New York; James Cordi, Supervising Deputy Attorney General of the California Department of Justice; Belinda Johns, Deputy Attorney General, California; Karl Emerson, Director of the Bureau of Charitable Organizations, Pennsylvania; and James Siegal, then Assistant Attorney General, New York.

The ACT reviewed and considered the observations and findings of numerous articles, reports, papers and books related to the purposes and uses of Form 990, including: "Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002," Marion R. Fremont-Smith & Andras Kosaras, Hauser Center for Nonprofit Organizations, The Kennedy School of Government, Harvard University (September 2003, Working Paper No. 20); "Pillaging of Charitable Assets: Embezzlement and Fraud," Marion R. Fremont-Smith, paper presented at the 16th Annual Conference sponsored by the National Center for Philanthropy and the Law at New York University School of Law; "Diversion of Charitable Assets: Crimes and Punishments," Marion R. Fremont-Smith; "Protecting the Public Interest: Fraud in the Government, Identifying and Investigating Financial Reporting Fraud of Non-Profit Entities", Gerard Zack, CFE, CPA, presented at the ACFE's 15th Annual Fraud Conference, July 2004; "Nonprofit Governance and Accountability," Lester Salamon (Listening Post

Project); 2002 Report to the Nation on Occupational Fraud and Abuse (ACFE); "Form 990," Cheryl Chasin, Debra Kawecki and David Jones, 2002 Exempt Organization Continuing Professional Education Text (IRS); "Update: The Final Regulations on the Disclosure Requirements for Annual Information Returns and Applications for Exemption," Michael Seto & Toussaint Tyson, 2000 Exempt Organization Continuing Professional Education Text (IRS); "The Value of Relationships Between State Charity Regulators & Philanthropy," David Biemesderfer and Andras Kosaras; "Charities Ready and Willing to E-file (Final Report)," Zina Poletz, Tom Pollak, and Linda Lampkin (The National Center for Charitable Statistics Center on Nonprofits and Philanthropy, The Urban Institute, June 2002); and the "Quality 990" project of the Urban Institute ([www.qual990.org](http://www.qual990.org) (last visited Apr. 20, 2006)), as well as numerous articles and resources from The Urban Institute.

The ACT's review included the following government reports: TIGTA 2006 Annual Audit Plan; IRS Date Book 2004; "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities" (GAO-02-526, April 2002); Responses to IRS Announcement 2002-87 asking for comments on redesign of Form 990; "Tax-Exempt Sector: Governance, Transparency, and Oversight Are Critical for Maintaining Public Trust," statement of David M. Walker, Comptroller General of the United States (GAO-05-561T, April 2005); "National Taxpayer Advocate 2005 Annual Report to Congress," (December 1, 2005); and "Business System Modernization: IRS Needs to Complete Recent Efforts to Develop Policies and Procedures to Guide Requirements Development and Management," (GAO-06-310, March 2006).

The following books were also reviewed: Marion R. Fremont-Smith, "Governing Nonprofit Organizations: Federal and State Law and Regulation" (The Belknap Press of Harvard University Press, 2004); Bruce R. Hopkins, "The Law of Tax-Exempt Organizations" (8th Edition) (John Wiley & Sons, 2003); and Charles O. Rossotti, "Many Unhappy Returns" (Harvard Business School Press, 2005).

The ACT reviewed the following testimony and white papers: Statement of Bruce Hopkins Before the House Committee on Ways and Means (April 2005); Senate Finance Committee Staff Discussion Draft (June 21, 2004); "Strengthening Transparency Governance Accountability of Charitable Organizations: A final report to Congress and the Nonprofit Sector," Panel on the Nonprofit Sector, Convened by Independent Sector, June 2005; and "Strengthening Transparency Governance Accountability of Charitable Organizations: A Supplement to the Final Report," April 2006.

## IV. Background

### A. History of Form 990

#### 1. Tax Exemption

The tax exemption for charitable organizations can be traced back to the earliest tax laws. The Tariff Act of 1894, 28 Stat. 509 (1894), provided that “nothing herein contained shall apply to ...corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes. . . .” Similarly, the Revenue Act of 1913, Pub. L. No. 16, 83 Stat. 114 (1913), which imposed the first income tax on corporations, exempted “ any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes. . . .” The income tax exemption has been expanded to include other classes of exempt organizations, so that now section 501(c)<sup>1</sup> describes 28 types of organizations that are exempt from federal income tax.

#### 2. Annual Filing Requirements

It was not until 1942, however, that the Treasury Department required that exempt organizations file annual returns. The Revenue Act of 1943 subsequently provided statutory authority for the Treasury’s administrative action.<sup>2</sup> Current law requires that all organizations exempt from tax under section 501(a) file an annual return unless there is an express statutory exception.<sup>3</sup> There are exceptions for: (a) churches, their integrated auxiliaries, and conventions or associations of churches; (b) certain organizations, other than private foundations, which normally have gross receipts of less than \$5,000;<sup>4</sup> and (c) the exclusively religious activities of any religious order.<sup>5</sup> Additionally, the Service has discretionary authority to provide exceptions where it determines “that such filing is not necessary to the efficient administration” of the tax laws, and uses this authority to limit filing for organizations other than private foundations to those organizations that have gross revenues in excess of \$25,000.<sup>6</sup>

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<sup>1</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>2</sup> The annual filing requirement predated the requirement that charitable organizations file an application for recognition of their tax exempt status. Prior to 1950, IRS regulatory activities were directed more towards the establishment of tax-exempt organizations, than to examination of these organizations. Interestingly, the exemption application requirement was included in the Internal Revenue Code of 1954. Subsequent Revenue Acts, Reform Acts, Restructuring Acts and the like dictated various new requirements for these exempt organizations through the years.

<sup>3</sup> IRC § 6033(a).

<sup>4</sup> IRC § 6033(a)(2)(A).

<sup>5</sup> IRC § 6033(a)(2)(A).

<sup>6</sup> IRC § 6033 (a)(2)(B); *Instructions for Form 990 and Form 990-EZ*, p.2

The Code requires that annual returns of all organizations state “specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe. . . .”<sup>7</sup> The regulations provide additional detail, requiring the submission of certain specific items of information by section 501(c)(3) organizations, including: gross income for the year; expenses attributable to such income and incurred within the year; disbursements within the year for the purposes for which the organization is exempt; a balance sheet showing the organization’s assets, liabilities, and net worth as of the beginning of the year; total of contributions and gifts received by it during the year, and the names and addresses of all substantial contributors; names and addresses of its foundation managers and highly compensated employees, as well as compensation and other payments made to each; lobbying expenses incurred (if applicable); information with regard to direct and indirect transfers to other organizations described in section 501(c); taxes paid under sections 4911, 4912, 4955, and 4958; such information as may be required with regard to excess benefit transactions and disqualified persons; and such information as the Secretary may require for purposes of carrying out the internal revenue laws.<sup>8</sup>

### **3. Public Disclosure**

The Revenue Act of 1950 required that certain sections of the two-page information return, Form 990-A (“Return of Organization Exempt From Income Tax” for 501(c)(3) organizations), be made available to the public, a requirement which was satisfied by filing requisite copies of the form with the IRS. However, amendments to the disclosure rules under section 6104 made by the Taxpayer Bill of Rights<sup>9</sup> in 1996 resulted in the returns being more readily available to the public. Additionally, the rapid growth of the Internet has further contributed to easy public access to the annual returns of many organizations. As a result, the universe of potential users of Form 990 has greatly expanded from predominantly regulators to include researchers, donors, the media, service providers, and others.

### **4. Development of Form 990 from 1941 to the Present**

Form 990 has grown from a two-page form in 1941, requesting information about revenues, expenses, and a few additional items, to a 15-page form in 2005, consisting of eight pages plus Schedules A (six pages) and B (a few pages or many, depending on number of contributors), with over 100 line items of information. New questions have been added through the years, creating an

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<sup>7</sup> IRC § 6033(a)(1).

<sup>8</sup> Treas. Reg. §1.6033-2.

<sup>9</sup> Taxpayer Bill of Rights § 1313, Pub. L. No. 104-168, 110 Stat 1452, 1475 (1996).

ever larger document but, for the most part, questions have rarely been eliminated.

**a. 1970 - 1980**

In 1970, pursuant to provisions of The Tax Reform Act of 1969,<sup>10</sup> Form 990-A (which had been filed only by section 501(c)(3) organizations) was discontinued and all exempt organizations (including private foundations) were required to file on the same annual return. This Form 990, consisting of four pages, replaced Form 990-A.

In 1971, Form 990 was reduced to two pages but a two-page Schedule A (requesting information about board and officer compensation, among other items) was added for section 501(c)(3) organizations. In 1972, Form 990-PF became the reporting document for private foundations.

Disclosure of transactions with trustees, directors, officers and other related parties was added to Schedule A in 1973. In 1976, questions about independent schools were added. In 1977, the first questions regarding lobbying expenditures appeared.

Significant changes were made to Form 990 in 1979, introducing the format that is still used today. Part I became the income statement (with optional columns to delineate restricted and unrestricted income and expense streams, which were eliminated in 1989). New questions regarding contributions raised through professional fundraisers, as well as questions about special fundraising events and activities were added to the income statement. The new Part II requested program revenue information, and new Part III requested allocations of expenses by function (including fees paid for fundraising). Part V required a balance sheet, showing balances as of the first day and last day of the year. Questions about donated services and use of facilities were added at this time. The list of officers, directors and trustees (and their compensation) was moved from Schedule A to Form 990.

NASCO was formed in 1979. One of NASCO's main goals has been to enhance information requested on Form 990 to meet states' needs and, since 1981, Form 990 has been accepted by many states in partial satisfaction of state filing requirements. Thus, changes to Form 990 since then have reflected states' needs as well as federal initiatives.

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<sup>10</sup> Pub. L. No. 91-172, 83 Stat. 487 (1969).



**b. 1981 - 1990**

In 1981, a question regarding conservation easements was added; it was eliminated in 1984. In 1981, the Service also added questions about program service activities; new optional columns on the balance sheet delineating unrestricted and restricted accounts (which were eliminated in 1989); and disclosure of states in which the organization files an annual return. In 1988, Schedule A was expanded to request information regarding transactions with other organizations. In 1989, new sections requiring information about income producing activities, the relationship of activities to exempt purposes, information about taxable subsidiaries, public inspection availability, and disclosure requirements were added. Form 990 and Schedule A were each five pages in length.

**c. 1990 - 2000**

Joint cost allocation questions were added in 1992, reportedly at the request of NASCO. Separate reporting of cash and non-cash contributions appeared in 1993, as well as a break-out on the balance sheet for tax-exempt bond liabilities. In 1994, the requirement in Part III to disclose the primary exempt purpose of the organization was added.

In 1995, the Financial Accounting Standards Board (“FASB”) issued significant pronouncements that dramatically changed the reporting of nonprofit organizations, both in substance and in presentation. As a result of these pronouncements, Form 990 underwent terminology changes. A reconciliation schedule (Part IV-A and Part IV-B) was added to reconcile the differences between generally accepted accounting principles (“GAAP”) for financial reporting and IRS Form 990 reporting. Schedule A underwent some reformatting, and Form 990 and Schedule A grew to six pages each.

Changes were made in 1996 in response to the Taxpayer Bill of Rights. Questions about intermediate sanctions and excess benefit transactions were added. One of the more curious additions to Form 990 was a question added in 1997 requesting the number of employees in the pay period ended March 12, an addition which is believed to have been made at the request of researchers outside of the Service.

Schedule B was added in 2000. The previously “attached list of contributors” was moved from the core Form 990 to new Schedule B, which also requested information about cash and non-cash contributions. A question about personal benefit contracts was added to the core Form 990 at the same time.

**d. 2001 - 2005**

In 2001, a request for organizations' website addresses and a question regarding compliance with SOP 98-2 (an accounting pronouncement on joint activities) were added. In the same year, a requirement to attach the list of disqualified persons to the Schedule A was changed to a requirement that organizations maintain (but not file) this information. A question on gaming was added in 2003.

In 2005, the Service added a number of questions in response to concerns about foreign activities and corporate governance, including disclosures regarding former officers, and foreign activities (*i.e.*, foreign grants made, foreign bank accounts and other types of information). Additionally, a new section on conflict of interest issues was added in 2005. A section for compensation paid to independent contractors other than for professional services was added to Schedule A in the same year.

**e. Summary**

As the chronicle above shows, the development of Form 990 has been primarily a process of adding questions as new laws were enacted and new concerns arose regarding the operation of tax-exempt organizations. Little information has been deleted. In addition, due to spacing, printing and timing issues, the form has grown like a patchwork quilt, so that today the form lacks a coherent organization and questions on related topics are scattered throughout the form.

**B. Comments on the Current Form 990**

The Service is aware that the current Form 990 has shortcomings and has sought comments on the form. Additionally, apart from the Service's solicitation of specific comments, many stakeholder groups and the Senate Finance Committee have commented on the form.

**1. Announcement 2002-87**

In Announcement 2002-87, 2002-2 C.B. 624, the IRS sought comments on the content and quality of the information provided on Form 990. The announcement explained recent changes made to the form and requested comment on additional areas where changes were being considered, including reporting on fundraising, functional allocations of expenses, joint costs, foreign grants, and corporate governance. The announcement also asked for suggestions for areas of improvement to the form to increase public confidence in the integrity of exempt organization disclosures. Several groups submitted comments to the IRS, including such disparate approaches as:

- Re-organize the format of the form, by creating a "core" form with attachments;

- Change the order of questions asked on the form, to better serve current needs, such as moving program service accomplishments to page one, and combining all compensation-related information into a single area of the form;
- Create one Form 990 for section 501(c)(3) and (4) organizations and a separate Form 990 for other section 501(c) organizations;
- Conform financial reporting on Form 990 with GAAP reporting, to enhance consistency between audited financial statements and tax reporting;
- Provide plain language instructions on proper accounting, which would improve financial reporting on Form 990;
- Improve consistency of terminology used in Form 990, its instructions, and to other reporting documents, such as the Form 1023, "Application for Exemption," Form 990-PF, and others;
- Use the National Taxonomy of Exempt Entities ("NTEE") codes for reporting programmatic purpose and financial information, so as to improve comparability studies and data entry by the states, and to provide a more reliable data base for the public;
- Address conflict of interest issues and other governance concerns, by broadening questions asked to include questions about executive compensation committees, audit committees, board relationships, and others;
- Consider the overly burdensome aspect of the form, and eliminate non-essential questions and disclosures;<sup>11</sup>
- Provide a list of resources where charities can obtain guidance in corporate governance and accountability matters;

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<sup>11</sup> The National Taxpayer Advocate found, "The estimated time to prepare and complete Form 990 and Schedules A and B is more than 214 hours -- almost 27 days for one person working eight hours a day." *National Taxpayer Advocate 2005 Report to Congress*, p. 292 (Dec. 2005).

- Provide guidance on corporate governance and accountability on the IRS website and through IRS education and outreach, but don't ask for governance information on Form 990;
- Include a question asking whether the organization has audited financial statements and whether its financial statements are available to the public; and
- Require quarterly filings of financial information, enhance disclosure on use of funds, fundraising allocation uses and percentages, and expand disclosure on the nature and extent of the organization's claimed expertise.

Additionally, a number of organizations expressed concerns that can best be summarized by the Association of Fundraising Professionals' ("AFP") statement that "the growing use of Form 990 as an all-purpose general data collection device" is troubling, and the "twin goals of governance reporting and oversight, and public accountability are conflicting and leading to a document that has become perilously overburdened." AFP further suggested that "public accountability involves not only providing information to the public, but also ensuring that the information is meaningful and understandable," a view that was echoed in some of the other submitted comments.<sup>12</sup>

## **2. Senate Finance Committee**

More recent criticisms of Form 990 have come from the Senate Finance Committee Staff Discussion Draft,<sup>13</sup> which suggested an overhaul of Form 990 is needed, and the Panel on the Nonprofit Sector, convened by Independent Sector, which also recommended that the IRS revise Form 990, and in fact created a "sub-group" to its Panel to provide suggestions for revision of both Forms 990 and 990-PF.<sup>14</sup> While no direct suggestions for revision have been publicly released, Independent Sector continues to work on this project.

## **3. National Center for Charitable Statistics**

The National Center for Charitable Statistics ("NCCS") is working, in collaboration with state charity officials, the Service, the CPA community and others, on suggestions for improvements to Form 990. It has developed a "Qual990" website to focus on suggested changes. Over the years, the "Quality Reporting Project" of NCCS has provided comments to the Service and NASCO regarding

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<sup>12</sup> *Comments of Association & Fundraising Professionals*, reprinted in *EO Tax Journal*, Jul/Aug. 2003, at 130.

<sup>13</sup> Released by the Senate Finance Committee on June 21, 2004, as a discussion draft.

<sup>14</sup> See [www.nonprofitpanel.org](http://www.nonprofitpanel.org).

suggested changes to Form 990. In the recent Annual Quality Form 990 meeting, hosted by NCCS in conjunction with the Service and NASCO, NCCS urged state regulators and the Service to use the Form 990 revision process as an opportunity to create a document that serves both federal and state needs, thus eliminating the state filing forms. As NCCS notes, electronic filing, now underway, makes this more of a possibility than it might have been previously. To develop a standard form to serve both states and the Service, NCCS made the following recommendations of interest to state regulators:

- Incorporate a professional fundraisers schedule;
- Include disclosure of legal or regulatory actions taken against organizations or their principals;
- Correlate Form 990 reporting to the appropriate state with a “signature line” that indicates that the 990 filed matches the one filed with the IRS;
- Clarify instructions for private inurement, conflicts of interest, and related party transactions;
- Add payment information for states;
- Add an ability to attach (perhaps as a PDF file) audited financial statements to satisfy a requirement of some states;
- Permit authentication by a second officer (as required by some states); and
- Add an ability to attach (again as a PDF file) Form 990-T for those states that require it.

NCCS also identified the reporting differences between GAAP financial statements and IRS tax filings as an important issue. It established a Work Group to provide recommendations for addressing these differences, which presented recommendations at the March 2006 Annual Meeting, including the following proposed changes to Form 990:

- Report unrestricted and restricted amounts separately from total amounts on Part I, so that the current line 18 “excess or (deficit) for the year” would become “Changes in net assets,” broken into unrestricted, temporarily restricted, permanently restricted, and total changes in net assets;

- Review and revise the current functional expense categories in Part II, so as to avoid information entered in the “other” category of expenses;
- Add governance questions to Form 990, including questions whether the board has approved Form 990, whether the organization publishes an annual report, and whether it undergoes an audit process;
- Clarify and restructure compensation information requested;
- Clarify the instructions to reporting special events so as to better match GAAP reporting; and
- Clarify the instructions for reporting gifts-in-kind; that is, provide clearer instructions as to what should and should not be reported on the 990.

### **C. Current Uses of Form 990**

Federal regulators, state regulators, and various segments of the general public each use Form 990 for different -- though complementary -- purposes.

The primary purpose of Form 990 is enforcement of federal tax law. The form generates information which the Service may use to assess whether the filing organization continues to comply with the requirements for tax-exempt status. It provides the Service with information that may trigger an audit or other contact with a filing organization. Obtaining a properly completed Form 990 helps the Service to ensure that tax exemption is only available to organizations that qualify for that privilege. Moreover, Form 990 serves to encourage some behaviors and discourage others. For example, the addition in 2005 of a question about the filing organization’s conflict of interest policy may drive the adoption of such policies by organizations that do not yet have them. Encouraging better behavior, however, has not been a primary focus of Form 990 until fairly recently.

State regulators, on the other hand, focus primarily on issues of governance, charitable purpose, and fundraising regulation. Even in states that require separate applications for recognition of tax exempt status (*e.g.*, California), state regulators generally direct their attention to improving the behavior of those governing charities and to the detection and prevention of solicitation fraud involving charities, rather than to eligibility for tax benefits. Disclosure of joint cost allocations for fundraising activities, for example, enables state charity regulators to identify organizations that may not be in compliance with state charitable solicitation laws.

Other portions of Form 990 may be equally important to both federal and state regulators, but with a different emphasis in each instance. Information about compensation and insider transactions, for example, is of particular interest to the IRS as it relates to whether an organization's tax exemption should be revoked because of private inurement or whether sanctions might apply under section 4958 or section 4941. To a state regulator, however, the same information may signal a diversion of charitable assets away from charitable purposes which they are obligated by state law to enforce.

Most states require exempt organizations to file a copy of Form 990, along with their state-specific filing forms. Some states only require a Form 990 from charities that solicit funds in their state. Some states require additional information from charities. For example, New Hampshire requires charities to submit evidence each year that they have re-adopted their conflict of interest policy,<sup>15</sup> while California requires both a tax form and a separate report to the Registry of Charitable Trusts within the Department of Justice,<sup>16</sup> and New York requires a separate report from charities that raise funds in that state.<sup>17</sup>

The ACT interviewed several state charity regulators<sup>18</sup> about their states' uses of Form 990. The regulators generally welcomed the addition of governance and fundraising questions, which are important for state law purposes, because it relieves them from the expense of obtaining that information on a separate state form.<sup>19</sup> They indicated that Form 990 assists them in enforcing state law not only by providing information to the oversight agencies but also by disclosing information to the general public. One state regulator said, "We're hoping that as Form 990 becomes more of a sunshine document, we can focus on the bad actors and let the public do the rest."

The public's use of Form 990, however, may not serve the oversight purpose that Congress envisioned when it imposed disclosure obligations on charities. The Tax Reform Act of 1969 required private foundations to make their annual returns on Form 990-PF available for public inspection at their office. In 1987, public

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<sup>15</sup> Telephone interview with Terry Knowles, Registrar of Charitable Trusts, Department of the Attorney General of New Hampshire, February 9, 2006.

<sup>16</sup> Cal. Bus. & Prof. Code § 17510.9 (1997).

<sup>17</sup> N.Y. Exec. Law § 174-b (Supp. 2006).

<sup>18</sup> Telephone interviews with Senior Assistant Attorney General Belinda Johns and Supervising Deputy Attorney General James Cordi of the California Department of Justice, January 23, 2006; Assistant Attorney General Karin K. Goldman of the New York Attorney General's charities Bureau, January 25, 2006; Terry Knowles, *supra n. [10]*.

<sup>19</sup> There is, however, some concern that as Form 990 includes more governance questions, there may be a "one size fits all" de facto standard that would not, in fact, fit the corporate governance or trustee duty laws of each of the 50 states .

charities became subject to a similar obligation.<sup>20</sup> The disclosure obligations of public charities expanded with the enactment of the Taxpayer Bill of Rights 2, P.L. No. 104-168, § 1313, 110 Stat. 1452 (1996), in 1996, which added to the Code the predecessor section to current 6104(d). That statute requires public charities to make copies of their three most recently filed Forms 990, with attachments,<sup>21</sup> available on request for free or for a reasonable handling fee or, alternatively, to make the returns widely available. The regulations under section 6104 make clear that a charity may satisfy the “publicly available” requirement by posting the relevant materials on the Internet.<sup>22</sup>

Since 1996, Internet access has become ubiquitous. It is now possible to view a public charity’s Form 990 on the web sites of various state charity regulators<sup>23</sup> and services such as GuideStar<sup>24</sup> as well as charity giving and charity rating portals that link to GuideStar.<sup>25</sup> Many charities post their Forms 990 on their own web sites. As a result, anyone with access to a computer and access to the Internet can view any charity’s Form 990 and draw their own conclusions from the information they find there.

This ease of access has not meant ease of use. Form 990 was not designed as a way for charities to explain themselves to the public, whether to donors, scholars, grant seekers, or investigative reporters. It is a technical document that assumes a significant degree of specialized knowledge on the part of the reader. Perhaps for that reason, representatives of both NCCS and GuideStar advised the ACT that their most frequent users are those whose work requires them to develop some level of specialized knowledge. These include academic researchers and students, charities seeking potential institutional funders, financial services firms seeking potential customers, other nonprofits looking for benchmark data for compensation or performance, and reporters seeking information for stories.<sup>26</sup>

Congress, in enacting section 6104(d), may have envisioned families reviewing the Form 990 of a charity before they made a donation, but that appears to be a

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<sup>20</sup> IRC § 6104(e), as enacted by the Revenue Act of 1987 (subsequently repealed by the Tax and Trade Relief Extension Act of 1998 (Pub. L. No. 105-277, Sec. 1004(b)(1), 112 Stat. 2681 (1998)).

<sup>21</sup> Schedule B to Form 990, which identifies major contributors by name and address, is not subject to these disclosure requirements.

<sup>22</sup> IRC § 6104(a)(3).

<sup>23</sup> For example, the California Attorney General’s charity search site is <http://justice.hcdcojnet.state.ca.us/charitysr/default.asp>.

<sup>24</sup> [www.guidestar.org](http://www.guidestar.org)

<sup>25</sup> Examples include [www.networkforgood.org](http://www.networkforgood.org) and [www.charitynavigator.org](http://www.charitynavigator.org).

<sup>26</sup> Participants in the NYU National Center on Philanthropy and the Law mini-conference in December 2005 noted that the NCCS has approximately 30,000 user sessions per month. GuideStar, which is more widely known, has some 8 million user sessions per year. It is not clear, however, how many individual users these sessions represent, since one user may account for many sessions.



rare event. Nonetheless, the public availability of Form 990 has made it significantly easier for news reporters to cover the sector and to expose what they believe to be its misdeeds. The combination of section 6104(d) and the Internet has enabled the public, through the news media, to learn more about the financial workings of the nonprofit sector than ever before.

## **D. Challenges and Limitations**

The remarkable diversity of the nonprofit sector, enduring characteristics of charities regulation, and significant cost constraints all present significant challenges in designing and implementing significant changes in Form 990. Additionally, the advent of electronic filing creates separate challenges, but may also provide opportunities, in achieving a reporting form that serves the purposes of Form 990's different stakeholders more effectively.

### **1. Diversity of the Nonprofit Sector**

With more than 1.3 million organizations now in the IRS Master File, the size of the nonprofit sector has almost doubled in the last decade. Approximately 317,000 of those organizations are charitable organizations that are filers of Form 990 or Form 990EZ.<sup>27</sup> Inasmuch as filing of Form 990 is required of many other non-charitable categories of tax-exempt entities as well, the number of exempt organizations that complete this form is far greater than the number of public charities filing the form. Educating the sector about the implementation of a new Form 990 will be a far more daunting challenge than it was in 1979, the last time the form was significantly revised.

However, the sheer size of the nonprofit sector only hints at what may be the greatest challenge in designing and implementing a new Form 990 – its diversity. Today, the organizations that must complete this form – in mission, programs, finances, and size and sophistication – are more diverse than ever before. Form 990 must be filed by major medical conglomerates, parent-teacher associations, industry trade groups, advocacy organizations, and many, many other types of entities that share little in common other than the recognition of their exempt status.<sup>28</sup> These nonprofits often feature dramatically different structures, revenue streams, asset management, compensation practices, and other characteristics that make capturing critical information on a single form a formidable proposition. That wide variety imposes challenges in both selecting the information to be sought in an improved version of the form and in presenting the questions in a

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<sup>27</sup> The Chronicle of Philanthropy, *America's Charity Explosion*, Ben Gose, January 5, 2005.

<sup>28</sup> The taxonomy of the nonprofit sector is set forth in "NTEE classification codes" used by the Urban Institute. Those codes currently include 26 different "major group" classifications for 501(c)(3) entities alone.

way that will encourage accuracy and compliance by all filers, notwithstanding their many differences.

Special challenges arise in the redesign and implementation of Form 990 for use by smaller, less sophisticated filers. The clear majority of Form 990 filers are small organizations, with annual revenues and assets under \$1 million.<sup>29</sup> The 2003 ACT project revealed that at least half of the organizations seeking exemption under section 501(c)(3) are not represented by professional advisors (lawyers or accountants).<sup>30</sup> Once operational, approximately half of the organizations filing Form 990 do not undergo a financial statement audit, and 28 percent do not have an outside professional or specialist to assist in the preparation of the form 990.<sup>31</sup> According to a 1994 IRS study of nonfiling exempt organizations, in about 24 percent of the cases the person responsible for maintaining the organization's books and records was unaware of the obligation to file Form 990 once the organization's gross receipts exceeded \$25,000.<sup>32</sup> This concentration of smaller, unsophisticated filers, without ready access to professional guidance, contributes to high error rates found in studies of the current Form 990, and will also create challenges in educating these filers in the use of a significantly modified Form 990.<sup>33</sup>

## 2. Form 990 as a Tool to Detect Diversion of Assets

The diversion of charitable assets is a subject that has received considerable attention in recent years, in published accounts of scandals, as evidence in support of legislative proposals, and in academic research.<sup>34</sup> Excessive

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<sup>29</sup> According to the Urban Institute's Center for Charitable Statistics, 483,989 of the 576,794 organizations that filed Form 990 in the two year period preceding January 2006 reported revenues of under \$1 million, and 459,311 of those organizations reported assets of under \$1 million. See National Center for Charitable Statistics, <http://nccsdataweb.urban.org> (last visited Apr. 20, 2006).

<sup>30</sup> *Project ASPIRE: EO Determinations Process Review*, Report of the Advisory Committee on Tax Exempt and Government Entities (May 21, 2003), pp. 1-10.

<sup>31</sup> Zina Poletz, Tom Pollak & Linda Lampkin, *Charities Ready and Willing To E-file*, (The Urban Institute, June 2002), p. 5. This survey sampled 485 nonprofit executives from exempt organizations of all sizes, to determine their capacity and receptivity to electronic filing.

<sup>32</sup> *IRS Exempt Organizations Nonfiler Study: Report of Findings* (December 1994).

<sup>33</sup> In one sampling of 600 forms filed with the IRS, 29% were found to have at least one error that could be detected by a review of the completed forms. *Assessing the Quality of Form 990 Data*, Mclean, Lampkin & Sumariwalla (1999).

<sup>34</sup> See, e.g., *Where Charity Begins and Profits Proliferate* (Boston Globe, July 27, 2003); *Some Officers of Charities Steer Assets To Selves* (Boston Globe, October 9, 2003); *Philanthropist's Millions Enrich Family Retainers* (Boston Globe, December 21, 2003); *AG's Charities Chief To Review Salaries at 2 Foundations* (Boston Globe, December 23, 2003); *IRS Vows To Step Up Audits of Nonprofits* (Boston Globe, June 23, 2004); *Nonprofits Outline Plans for Reform* (Boston Globe, March 2, 2005); *AG To Propose Strict Rules for Charities* (Boston Globe, May 5, 2005); but see Marion R. Fremont-Smith & Andras Kosara, *Wrongdoing By Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 Exempt Org. Tax Rev. 25 (2003)(finding only 54 reported breaches of fiduciary duty and 104 incidents of criminal

compensation of executives, fraudulent self-dealing by nonprofit board members, and improper entanglement of charitable assets with business interests are staples of the popular media whenever they are revealed, often creating an impression of a high level of such activity.<sup>35</sup>

The actual extent of asset diversion in the nonprofit sector, however, remains elusive for several reasons. Charities regulation is balkanized: not only the IRS, but also every state and countless localities have authority to pursue wrongdoing through one or more enforcement offices, with criminal and civil authority typically separated. This long-standing federalism makes the sharing of information and tracking of outcomes tremendously difficult. More problematically, the resources made available to the enforcement authorities at every level to address nonprofit illegality are profoundly inadequate, with only a handful of state Attorneys General maintaining staffing at even one full-time lawyer to perform a civil enforcement function for the entire state.<sup>36</sup> Notwithstanding its current emphasis on enforcement, the Service is also dramatically under-funded to detect nonprofit illegality at a rate that even begins to keep pace with the growth of the sector; only one percent of the exempt organizations that are under the IRS's jurisdiction are subject to an audit by the IRS each year.<sup>37</sup>

Nevertheless, the use of Form 990 as an enforcement tool for the detection of diversion of assets and other wrongdoing remains one of its central purposes, and any redesign of the form must recognize that the complexity of such wrongdoing has only increased with the growth of the sector itself.<sup>38</sup> While financial reporting without substantial audit enforcement resources may be a

defalcation, with 6 instances falling into both categories). See also Gerard Zack, *Protecting the Public Interest: Fraud in the Government. Identifying and Investigating Financial Reporting Fraud of Non-Profit Entities* (presented at the Association of Certified Fraud Examiners' 15th Annual Fraud Conference, Las Vegas NV, July 2004).

<sup>35</sup> See, e.g., *Private Foundations Give a Lot – To Trustees* (Philadelphia Inquirer, August 30, 2003).

<sup>36</sup> See *Report on NAAG/NASCO Survey* (National Association of Attorneys General, 1996)(reporting that, although the Attorney General has common law jurisdiction to supervise the administration of charitable assets in 34 jurisdictions, and 40 states require fundraising professionals and/or charities to register, there are only about a dozen states that have set up sections to handle charitable matters exclusively); David Biemesderfer & Andras Kosaras, *The Value of Relationships Between State Charity Regulators & Philanthropy*, p. 4 (Council on Foundations and the Forum of Regional Associations of Grantmakers, 2006) (profiling the charities enforcement function in 16 states and noting that while the NAAG/NASCO study of the staffing of state Attorneys Generals' charities offices is now ten years old, "it is fair to say that over the past several decades there has not been a significant increase in the number of attorneys assigned to charity oversight or in the states with the highest staffing levels.").

<sup>37</sup> *Reviewing IRS Policies and Procedures To Leverage Enforcement Recommendations (RIPPLE)*, p. 196 (Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities, June 9, 2004).

<sup>38</sup> See *Internal Revenue Service Exempt Organizations Implementing Guidelines for Fiscal Year 2006* (October 25, 2005), including Commissioner Mark Everson's report on progress by EO in combating abusive tax avoidance transactions (ATAT).

limited tool for ferreting out deliberate wrongdoing, it is not without value. An improved, well-designed Form 990 should capture relevant transactions in as much detail as the balance between enforcement needs and filing complexity will permit, and enable the IRS to detect diversionary activity in reported patterns of assets, revenues and expenditures notwithstanding the skill of many wrongdoers in covering their tracks.<sup>39</sup> In particular, a redesigned Form 990 will be most effective as an enforcement tool to detect diversions if the financial and other information includes "audit triggers" that can reveal aggregate problematic patterns and extracts that information in a format that resists both innocent misunderstanding and willful evasion.

### **3. Incremental Implementation**

Absent cost considerations, a revised Form 990 would be introduced in a single filing year, accompanied by sufficient outreach to educate filers, preparers, and other stakeholders about its use. However, cost considerations will likely compel the IRS to introduce a new Form 990 incrementally in order to accomplish its goal within the budgetary realities of annual appropriations and the anticipated reluctance of contracting software designers to assume the economic risks of a single comprehensive revision. Those constraints will dictate an approach that can potentially cause considerable confusion among filers who are without professional assistance in completing the form. As a result, the IRS will incur additional costs in educating users about those changes as they are introduced over a period of years.

Nevertheless, incremental introduction of a new Form 990 is not without benefits. This approach would offer an opportunity to test both a revised core form and new schedules, allowing further changes in subsequent years if either the form or its instructions prove to be imperfect. This flexibility should help the Service address what will be a central tension in this initiative: balancing the need for a stable, commonly understood reporting tool with the ongoing need to be adroit in responding to evolving enforcement needs and changed circumstances in the nonprofit sector. As a result, the ability to revise Form 990 during the years of its implementation may prove to be more a blessing than an incremental approach at first appears.

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<sup>39</sup> Even the most obvious enforcement traps, the straightforward confessional questions such as whether the filing organizations engaged in any excess benefit transactions, have value beyond serving as a warning to the unintentional violator. Those questions may serve to toll the statute of limitations on claims by the IRS and serve as the basis for enforcement action that would otherwise be time-barred.

#### 4. Challenges and Opportunities of Electronic Filing

The Internal Revenue Restructuring and Reform Act of 1998 requires that the IRS be prepared to receive 80% of all filed returns electronically by 2007.<sup>40</sup> For many years preceding that mandate, the Service had been working on introducing "e-filing" for its filers, including tax exempt organizations.<sup>41</sup> That work has been daunting due to the limited resources available for the necessary technology upgrades and the very diverse characteristics of the constituent groups that would be included in such a program.<sup>42</sup> Today, the IRS is beginning implementation of e-filing for the largest exempt organizations, the first step toward a system that promises enormous benefits for the Service and for every category of tax exempt customer that the agency must serve.

Electronic filing creates both opportunities and challenges for the design and implementation of an improved Form 990. The benefits include, as a basic feature of this technology, a reduction in the error rates that continue to plague the returns filed using the current version of the form.<sup>43</sup> For example, electronically filed returns will automatically require correction by filers of omitted information and erroneous calculations; the technology can be designed to reject those returns instantly with instructions for correction of these errors.

Electronic filing will also permit the IRS to set the "audit triggers" necessary to detect patterns of diversionary activity in cost-effective programs that are not possible in manual reviews today, given the agency's limited resources. Today, only part of the information contained in Forms 990 filed with the IRS is entered into a database that allows analysis for enforcement purposes. Electronic filing will permit virtually automatic entry of important information into databases that can be programmed to produce reports about expense patterns and asset management for earlier, more precise identification of audit targets at a substantially lower cost.

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<sup>40</sup> Pub. L. No. 105-206, 112 Stat. 685 (1998).

<sup>41</sup> On January 12, 2005, the IRS released new regulations requiring exempt organizations with total assets of \$100 million or more that file more than 250 returns with the IRS, applicable to tax years beginning after December 31, 2006. See *New Regulations Adopt Requirements for E-Filing*, [www.irs.gov](http://www.irs.gov) (last visited Apr. 20, 2006) (search "e-filing regulations").

<sup>42</sup> See Charles O. Rossotti, *Many Unhappy Returns*, pp. 139 *et seq.* (Harvard Business School Press, 2005).

<sup>43</sup> In the Temporary Regulations published January 12, 2005, mandating e-filing for larger charitable organizations, the IRS introduced the regulations with the observation, "Information Returns required to be filed under section 6033, which include Form 990, "Return of Organization Exempt from Income Tax," and Form 990-PF, "Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation," that are filed on paper have an error rate of approximately 35 percent. The error rate for paper returns is due in roughly equal parts to IRS processing errors and taxpayer return preparation mistakes. By contrast, electronically filed returns have an error rate of less than one percent because these returns are subject to screening by the IRS prior to being accepted and are not required to be input manually by the IRS." See also *Assessing the Quality of Form 990 Data*, Mclean, Lampkin & Sumariwalla (1999).

However, there are also challenges inherent in e-filing that affect both the design and the implementation of an improved Form 990. Whatever its specifics, an improved Form 990 will include questions that seek numerical information about revenues, expenses, and assets and also questions that seek narrative information about an exempt organization's mission and activities. Designing an improved Form 990 that is searchable in both respects may call for the use of both field-based search tools, the relatively inflexible devices that typically produce reliable results for numerical data, and text search mechanisms, such as Boolean systems, that focus on terms and word combinations and produce results with increasing accuracy using optical recognition software. To maximize the value of the new form as an enforcement tool, the choices made in design technology must enable the IRS to retrieve and identify patterns in both quantitative and qualitative information.

Another barrier to realizing the benefits of electronic filing is statutory. Patterns of diversionary behavior and other useful data about tax exempt organizations are only meaningful if based on statistically significant numbers of filers. However, current law prohibits the Service from requiring e-filing by any reporting entity, tax-exempt or tax paying, unless that entity files at least 250 returns in a filing period.<sup>44</sup> This mandate dates from a time when the burdens of electronic filing were far greater than they are today. Enactment of pending legislative proposals that would increase the number of reporting entities, exempt and otherwise, that can be subject to mandatory e-filing is a prerequisite to realizing some of the most significant benefits of electronic filing.

Implementation of electronic filing does raise questions about the ability of smaller exempt organizations with limited technology budgets to comply with such a mandate. However, there is evidence that any "digital divide" that might have impaired the ability of smaller organizations to participate is diminishing. Significant numbers of small exempt organizations now report that such access is available to them, through either the exempt organization itself or Internet service maintained by individuals associated with the group.<sup>45</sup> Recent experience with the e-filing program for filers of Form 990-EZ is also encouraging; e-file statistics for the year to date ending December 22, 2005 reveal that almost 20 percent of the returns filed by exempt organizations during that period were Forms 990-EZ.<sup>46</sup> Thus, it appears that by providing incentives that encourage

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<sup>44</sup> IRC § 6011(e)(2).

<sup>45</sup> Poletz, Pollak & Lampkin, pp. 7-9. Among the filers whose Form 990 is prepared without the assistance of accountants or other outside professionals, more than 86 percent of those with fewer than ten employees reported that they had access to the Internet. Overall, 73 percent of all executives surveyed indicated that they would be very likely or somewhat likely to file their organization's Form 990 electronically, as long as there was free, easy to use software available to do so. The Urban Institute subsequently began making such software available on request to Form 990 filers without charge.

<sup>46</sup> "EO Update," January 6, 2006.

e-filing, such as reduced filing costs, and by phasing in e-filing for smaller organizations, any remaining barrier caused by limited Internet access can be overcome.

## V. Recommendations

As the Service continues its project to redesign Form 990, we recommend that it follow the policy objectives and guiding principles set forth below. The questions asked on the 990 should be consistent with, and tested against, these principles.

### 1. **Form 990 should be designed primarily to assess whether the filer is complying with federal tax requirements.**

The mission of the Service is to ensure compliance with the federal tax laws. This may be accomplished through education and enforcement, and Form 990 can support both means of tax administration. To ensure that the form remains focused on meeting the Service's core mission, Form 990 should be designed to determine compliance with federal tax law. If the needs of federal tax administration conflict with other purposes or needs, federal tax administration should be given priority over other needs.

### 2. **IRS should continue to accommodate the needs of the states as long as they do not adversely affect the IRS's primary mission or unduly burden filers.**

Standardization of reporting requirements is desirable because it creates efficiencies and reduces costs. Currently, many states accept Form 990 in whole or in part. Since 1981, the Service has accommodated state requests that have broad-based acceptance among the states.

Cooperation between federal and state enforcement authorities enhances exempt organization compliance and maximizes the efficient use of limited resources. Therefore, we continue to recommend, as in our reports from 2004<sup>47</sup> and 2005,<sup>48</sup> the amendment of section 6103 to permit the Service to share information and coordinate enforcement efforts with state agencies charged with overseeing and monitoring exempt organizations.

To the extent that the Service and the states want to obtain the same information from filers of Form 990, a combined form is in the interest of

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<sup>47</sup> *Reviewing IRS Policies and Procedures to Leverage Enforcement Recommendations* (RIPPLE), p. 21 (Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities, June 9, 2004).

<sup>48</sup> *Recommendations to Enhance the Compliance of Newly Formed Charities* (IMPROVE), p. 21 (Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities, June 8, 2005).

the filers, as well as the federal and state governments. However, the Service should be cautious about adding questions of relevance to only a limited number of states. Such questions add to the length and complexity of the form and impose a burden on those not required to file in those states.

**3. Form 990 and its instructions should be as understandable to a person unschooled in the law of tax-exempt organizations as possible without compromising its primary purpose.**

Many preparers of Form 990 are volunteers or practitioners with limited experience in the complexities of the law of tax-exempt organizations. It is therefore critical to accurate reporting that the form and its instructions be easily understandable by non-specialists.

After decades of federal policy supporting public availability of Form 990, the form now is in fact widely available. Making the questions clear enables both the IRS and the public to get better information. The clearer the questions, the easier it will be for the filer to complete the form accurately and for the public to understand it.

Although Form 990 is now widely available, its primary purpose is not to communicate with the public. Nevertheless, it is in everyone's interest for the form to be as clear and readable as possible.

**4. Form 990 should consist of a core form with schedules organized by topic and type of organization**

The core form would be filed by all section 501(c) organizations and should be limited to information applicable to all filers. The core form should include:

- Identifying and contact information;
- Type of organization;
- Description of the organization's primary exempt purpose;
- Statutorily required financial information;
- Changes not captured in the schedules that might affect exempt status, such as changes in mission, activities or governing instruments; and
- Questions that would direct the filer to complete particular questions (e.g., "Did you engage in lobbying?").

It also would be helpful to include a checklist of all Form 990 schedules to assist organizations in determining which schedules they need to file.



All organizations should be required to complete the identifying and contact information section of the core form, including organizations below the \$25,000 filing threshold.<sup>49</sup> A core form with schedules may make Form 990-EZ unnecessary.

Separate schedules should be designed to deal with specific issues, such as compensation, related parties, foreign activities, and lobbying. Questions related to the same topic should be grouped together.

Schedules could be added for a limited period to obtain information on specific areas of noncompliance that the IRS wants to target, and could then be deleted when a particular project is completed. Current issues that might have specific schedules include conservation easements and credit counseling. In order to provide greater enforcement flexibility, the IRS should continue to use targeted initiatives, such as the recent credit counseling initiative, to gather information between annual filings, rather than burden the form with additional schedules.

The Service also should consider eliminating questions where possible and requiring filers to retain information in their records which would be available for inspection. The current form is burdensome for filers to complete and probably contains more information than the Service can efficiently use.

By streamlining the core form and using issue-specific schedules, both the Service's and the filers' resources will be conserved and other users will be able to more easily find information.

**5. Questions on Form 990 should be formulated to obtain evidence or facts which will reveal whether the filer has complied with federal tax law.**

Currently, questions on the form are designed to (a) elicit direct information about compliance (including "confessional" questions); (b) elicit information that the IRS believes might suggest noncompliance indirectly (evidentiary questions); and (c) drive behavior toward compliance (*i.e.*, governance questions).

Direct information questions, such as "Did you engage in an excess benefit transaction?" may be of limited utility to detect deliberate wrongdoing. However, direct questions have a value beyond the specific

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<sup>49</sup> We also made this recommendation in 2005. See *Recommendations to Enhance the Compliance of Newly Formed Charities* (IMPROVE), p. 14 (Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities, June 8, 2005).

information provided, in that false responses may give the IRS additional time within which to pursue enforcement by tolling the statute of limitations.

Evidentiary questions should be formulated to obtain evidence or facts which will reveal whether the filer has complied with federal tax law. However, evidentiary questions on Form 990 are not a substitute for an examination and should be used sparingly lest the form become too lengthy and burdensome. Additionally, there should be a clear correlation between the questions asked and the possible determination of wrongdoing. Questions regarding governance “best practices,” such as whether an organization has a conflict of interest policy, are probably insufficiently connected to the elements of any violation of the tax code to prompt the efficient use of enforcement resources. For example, the fact that poor governance practices are found where wrongdoing has occurred does not suggest that poor governance is *always* correlated to violations of the tax code.

By contrast, the current form contains an example of a good evidentiary question. Schedule A, Part III, Question 2 asks: “During the year has the organization either directly or indirectly engaged in any of the following acts with any substantial contributors, trustees, directors, officers, creators, key employees, or members of their families or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner or principal beneficiary?” This question identifies a group of organizations that have one of the elements of an excess benefit transaction. By use of follow-up questions targeted at another element of an excess benefit transaction -- the presence or absence of a fair market value or arms’ length transaction -- the organizations most likely to have violated the law can be identified.

Other questions included on Form 990, such as direct questions about violations of law, also serve the purpose of influencing the behavior of filers to encourage compliance with the tax law. However, any organization behavior selected for such encouragement should be prescribed by the tax code or, at a minimum, characterized by clear and consistent norms in other legal mandates. For example, practices such as the creation of a separate audit committee may be useful in larger but not smaller organizations, and may be required by some state laws but absent from others. Such questions do not have a sufficient nexus to the tax law for inclusion on Form 990.

Each question on Form 990 either should tie directly to tax law compliance or it should provide evidence of whether the filer has complied with the law.

**6. Statutory limits on mandatory electronic filing should be removed and mandatory electronic filing should be phased in.**

Electronic filing improves accuracy and allows the Service to process information more rapidly, economically, and effectively. Under current law, the Service can only require electronic filing for organizations that file more than 250 returns in a tax year. This statutory threshold dates from a time when electronic filing was burdensome for all but the largest taxpayers. Recent studies have shown that even smaller nonprofits would be willing and able to submit Form 990 electronically. Indeed, many small and mid-sized nonprofits are already filing Form 990 electronically, even though they are not required to do so. With the rapid expansion of affordable Internet access, the 250-return threshold should be reassessed. We strongly support amending current law to lower or remove the threshold.

Absent statutory change, the Service should consider whether incentives might be used to encourage electronic filing, such as continuing to provide a link from the IRS website to the free e-file software produced by the NCCS. The airline industry encouraged customers to shift from paper tickets to electronic tickets by charging a fee for paper tickets but waiving it for electronic tickets. This approach may not be feasible for a governmental agency, but it illustrates the role that effective incentives can play. We encourage the IRS to continue to work with the nonprofit sector to promote e-filing.

**7. Form 990 should be redesigned in its entirety and implemented as quickly as possible.**

Introducing a redesigned Form 990 poses a significant budgetary challenge. Ideally, the new form, with schedules and instructions, would be introduced in a single tax year. It would be challenging for filers and preparers to learn the new form, but this could be addressed through courses and workshops provided by both the IRS and the private sector. After the initial implementation year, we expect that filers and preparers would quickly adapt to the change. For the IRS, however, introducing the new form in one tax year presents financial and training costs that may exceed its budget.

A gradual approach also presents significant challenges. It requires filers and preparers to learn a new form each year until the final Form 990 is released. The IRS and vendors – as well as the states that use Form 990 – will incur programming, training, and other costs during each year of the implementation period. We recognize, however, that a phased-in implementation may be the only feasible approach and it may be a lengthy process. There appear to be two options for a phased-in approach.

One option would be to redesign the core form and introduce the new schedules as budgetary and other considerations allow. The disadvantage to this approach is that during the implementation period some of the information currently requested on the core form would not appear on the new form until it was phased in on a schedule. This disadvantage could be mitigated to some extent by requiring filers to maintain records for the issues and topics that are temporarily eliminated from the form. However, the absence of some questions for even a year or two could affect data collection, a function that the Service has been seeking to enhance in order to improve its ability to detect trends and efficiently use its enforcement resources. If this approach were adopted, the Service would need to evaluate its data requirements as well as statutory requirements for questions on Form 990 and Congressionally mandated reports.

A second option for a phased-in approach would be to leave the existing form intact and introduce new schedules. The final step with this option would be to strip the old core form of redundant questions and redesign it. The disadvantage to this approach is that some information must be entered in the old core form as well as the new schedules during the phase-in period.

Regardless of the phase-in approach that is used, we recommend that schedules for compensation, related party transactions, international activities and non-cash contributions be given the highest priority. If a phased-in approach must be adopted, the Service should solicit input from software vendors, state charity regulators, the nonprofit filing community, and other stakeholders regarding methods of implementation in order to minimize the cost and disruption to all parties.

While every approach presents challenges, introduction of the redesigned Form 990 in a single tax year is preferable if the IRS can meet the budgetary challenges.

**Advisory Committee on  
Tax Exempt and Government Entities  
(ACT)**

**DOCUMENT COMPLIANCE PROGRAM FOR  
403(b) ARRANGEMENTS**

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June 7, 2006

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## TABLE OF CONTENTS

I. EXECUTIVE SUMMARY .....	3
II. INTRODUCTION .....	5
A. Reasons for the Report .....	5
B. The ACT's Objectives .....	6
C. Summary of Recommendations .....	6
D. Data Gathering Process .....	7
III. BACKGROUND .....	8
A. History of 403(b) Arrangements .....	8
B. The 403(b) Market .....	14
C. Funding Structure .....	16
D. Recent Changes in 403(b) Plan Requirements .....	17
IV. SCOPE OF THE PROBLEM .....	20
A. Employers and Participants Affected .....	20
B. Preconceived Notions of 403(b) Requirements Based on History .....	20
C. The Written Plan Requirement and Title I of ERISA .....	21
D. Determination of the Adequacy of the Plan Document .....	21
V. PROPOSAL/RECOMMENDATIONS .....	22
A. Non-ERISA, Simplified Plan Document Program .....	22
B. Pre-Approved Plan Program .....	23
C. Individually-Designed Plan Approval Program .....	26
VI. ADDITIONAL CONSIDERATIONS AND CONCERNS .....	27
A. Concerns Regarding the Use of Pre-Approved Plans .....	27
B. Determination Letter Program .....	28
C. Model Amendments for 403(b) Custodial and Annuity Contracts .....	28

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## I. EXECUTIVE SUMMARY

### **The Problem**

On November 16, 2004, the Internal Revenue Service (“IRS”) issued proposed regulations under Internal Revenue Code Section 403(b). One of the most important aspects of these proposed regulations is the requirement that a 403(b) arrangement must be maintained pursuant to a written plan which satisfies the requirements of Code Section 403(b) and contains all of the terms and conditions for benefits under the plans.

The 403(b) market is substantial, comprised of an estimated 24,000 arrangements, holding over one half trillion dollars of assets for the benefit of approximately 6.8 million employees. The written plan requirement is an important new step in protecting participant rights and promoting compliance with the law.

Since a written plan has never before been a tax law requirement, currently the Internal Revenue Service lacks a program or procedures to assure compliance with this important new requirement. Other than seeking a private letter ruling, there has been no way for an employer adopting plan documents to ensure that its plan complies, in form or substance, with the rules. The option of adopting a pre-approved 403(b) document is not available, and the IRS does not issue determination letters covering individually designed 403(b) plans.

### **The ACT’s Objective**

The purpose of this project is to identify the challenges that 403(b) arrangements will face in complying with the new plan documentation requirement and to identify possible solutions, including the development of a model plan and a pre-approved document program for 403(b) arrangements.

### **Guiding Principles**

The first goal set forth in the IRS’s 5-year Strategic Plan 2005-2009, published in 2004, is to improve taxpayer service. As part of that goal, the IRS has committed to ensure that guidance is responsive to the needs of the public. Publication of comprehensive regulations for 403(b) arrangements will bring greater structure and clarity to a part of the retirement plan system that historically has received limited and sporadic guidance. The development of a document compliance system similar to the system that exists for qualified retirement plans will enhance enforcement of the Internal Revenue Code.

### **Recommendations**

The ACT’s principal recommendations are as follows:

- (1) The IRS should create a model document to satisfy the written document requirement for salary reduction only 403(b) arrangements that are not subject to Title I of ERISA;

- (2) The IRS should expand the scope of the existing master and prototype plans (“M&P”) program, and if appropriate, the volume submitter (“VS”) program to include 403(b) arrangements.
- (3) The IRS should create a limited determination letter program addressing plan documentation requirements for individually designed 403(b) plan documents.

For 403(b) salary reduction-only arrangements that are not currently subject to Title I of ERISA, the ACT recommends that the IRS create a simple salary reduction-only model document that “wraps around” the custodial and/or annuity contracts entered into with the 403(b) arrangement custodian or annuity provider. This simple “wrap around” plan document would contain those provisions that are required for 403(b) arrangements that would not normally be found in the custodial or annuity contract. It could be a published IRS form, such as the Form 5305 series of forms, or could be a separate model document that the IRS develops.

The ACT strongly believes that the implementation of mechanisms whereby adopting employers can utilize and rely upon documents that are consistent with the requirements of Internal Revenue Code Section 403(b) and published IRS guidance will facilitate overall plan compliance.

The IRS has a well-developed program for M&P and VS plans established under Section 401(a) of the Code. Extending these existing programs to 403(b) arrangements will be the most expeditious and cost effective way of increasing compliance.

A significant number of 403(b) plans are maintained by large employers such as hospital systems and universities. These employers frequently use individually designed plans. The ACT recommends a limited determination letter program that would allow these employers to receive assurance that their plans, in form, satisfy the requirements of Section 403(b).

## II. INTRODUCTION

### A. Reasons for the Report

This project arose from a perceived need for the IRS to provide additional compliance support for 403(b) arrangements.<sup>1</sup> The need for compliance services is particularly acute in light of the currently proposed regulations (expected to be finalized sometime in 2006) regarding 403(b) arrangements.

On November 16, 2004, the IRS issued proposed regulations under Section 403(b)<sup>2</sup> (69 FR 67075, corrected on December 21, 2004 at 69 FR 76422). These proposed regulations, the first comprehensive set of 403(b) regulations in forty years, move 403(b) arrangements closer in concept to qualified retirement plans. One of the most important aspects of these proposed regulations is the requirement that 403(b) arrangements must be maintained pursuant to a written plan which satisfies the requirements of Section 403(b) and contains all of the terms and conditions for benefits under the plans.<sup>3</sup>

Although the proposed regulations will mandate documents that satisfy the statutory and regulatory requirements, other than seeking a private letter ruling, there is no current way for an employer adopting such documents to ensure that its arrangement complies, in form, with the rules. The option of adopting a pre-approved 403(b) plan is not available.<sup>4</sup> Nor will the IRS issue determination letters covering individually designed 403(b) plans.<sup>5</sup>

The IRS does issue private letter rulings (“PLRs”) for 403(b) arrangements, but the process of obtaining a ruling for a 403(b) arrangement is usually more complicated and more expensive than the process of obtaining a determination letter for a qualified retirement plan. Also, if an employer requests a private letter ruling on limited issues in connection with a 403(b) plan, the letter will not provide the same scope of reliance as a determination letter issued for a qualified retirement plan.<sup>6</sup> Finally, it would appear that the IRS must expend greater resources to process a private letter ruling request than it does in processing determination letter requests (particularly if the plan document is pre-approved).

Recently, the IRS has been receptive to the prospect of designing a documentation compliance program for addressing 403(b) arrangements. In the Extra Special Edition of the *Employee Plans News* dated November 17, 2004, Carol Gold, Director of the Employee Plans Division (“EP”), stated that EP has been considering the future

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<sup>1</sup> The term “403(b) arrangement” refers to tax sheltered annuities, custodial accounts, retirement income accounts, and 403(b) plans.

<sup>2</sup> References to “Section” are references to sections of the Internal Revenue Code of 1986, as amended.

<sup>3</sup> (Prop. Regs. §1.403(b)-3(b)(3)).

<sup>4</sup> Under section 6.03(6) of Rev. Proc. 2005-16, IRS opinion letters will not be issued for annuity contracts under section 403(b).

<sup>5</sup> See section 3.02(1) of Rev. Proc. 2005-6.

<sup>6</sup> See Announcement 2001-83.

possibility of a determination letter program for 403(b) plans. Furthermore, in Announcement 2001-83, the IRS stated that the results of the discussion of qualified plan determination letters could be extrapolated to apply to 403(b) plans.

## **B. The ACT's Objectives**

The ACT set out to identify the significant provisions that would be required in every 403(b) arrangement and the methods of implementing a Section 403(b) document compliance program.

The specific objectives of this ACT project are to:

- review the challenges that 403(b) arrangements will face as plan sponsors try to comply with the new 403(b) documentation requirement;
- identify solutions to these challenges, specifically focusing on the creation of an approval program for documentation of 403(b) arrangements and other methods of compliance.

## **C. Summary of Recommendations**

In response to the written plan requirement included in the new Section 403(b) regulations, the ACT recommends that the IRS implement an approval program consisting in part of a M&P and, if appropriate, a VS program for 403(b) arrangements similar to its existing M&P and VS programs.<sup>7</sup> Expansion of the existing pre-approved plan program will be the most expedient and cost effective way of assisting plan sponsors in complying with the written plan requirement. Additionally, although there will be a substantial "front end" effort by the IRS, the pre-approved plan program should permit the IRS to "leverage" its resources in implementing this aspect of the new 403(b) regulations.

In addition, the ACT recommends a limited determination letter ("DL") program for individually designed 403(b) arrangements. The limited DL program would only rule on the form of the plan document. It would not address coverage or nondiscrimination issues as does the regular DL program for plans governed under Section 401(a). The IRS currently has a strong determination letter program for individually designed plans established under Code Section 401(a). The ACT believes that this program can be expanded to include 403(b) arrangements on the more limited basis recommended in this report.

Acknowledging that many existing 403(b) arrangements involve only minimal employer involvement, the ACT further recommends that the IRS publish a simple salary reduction-only model document that can be used in conjunction with custodial and/or

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<sup>7</sup> Based upon the ACT's research, it is not clear whether a VS program is needed. Most small plans will find a prototype plan most useful. There are a significant number of large plans that will likely continue to desire to use individually designed documents.

annuity contracts to comply with the written plan requirement. This document will contain those provisions that must be included in a 403(b) salary reduction arrangement and that would normally not be found in the custodial or annuity contract. The model document will be particularly beneficial in cases where employees obtain 403(b) arrangements directly from the Section 403(b) custodian or annuity provider without the guidance of benefit attorneys or other professionals.

#### **D. Data Gathering Process**

In developing its recommendations, ACT members first interviewed representatives of several financial institutions that have significant experience both in providing investment products for 403(b) arrangements and in providing plan documents and investments for qualified retirement plans. The purpose of these interviews was to evaluate and understand the current mechanisms for delivering 403(b) plan services and to determine whether the market would be receptive to a 403(b) document approval program. ACT members also had several conferences with staff members in the Employee Plans Division of TE/GE to learn about current resources devoted to review of 403(b) plan documents, the IRS's experience with the M&P and VS programs for qualified retirement plans, and the feasibility of creating a 403(b) arrangement document approval program patterned after the IRS's existing programs. The ACT spoke to a representative of the Department of Labor (DOL) to better understand the exemption for certain 403(b) arrangements from Title I of ERISA. Finally, ACT members interviewed several members of the American Bar Association Section of Taxation whose practices include assisting clients with 403(b) arrangements to determine whether and to what extent employers and employees would benefit from a Section 403(b) arrangement model plan or document approval program.

During the course of these meetings and interviews, several broad themes emerged.

- The 403(b) market is extraordinarily varied and segmented. As a result, the seemingly simple requirement of a written plan will be a significant challenge to implement.
- There is a broad consensus that more guidance and clarity is needed in the 403(b) market. If the final regulations require a written plan for Section 403(b) arrangements, model or pre-approved documents (in addition to individually designed plan documents) will be needed and welcomed by the benefits community.
- 403(b) arrangements present a unique "document" challenge, because such arrangements typically consist of both a plan document and one or more annuity contracts or custodial agreements. Additionally, some annuity contracts and custodial agreements are individual contracts and agreements while others are group contracts and agreements. It will be difficult to develop a model or pre-approved document that will be compatible with each and every possible annuity contract or custodial agreement.
- Many salary reduction-only 403(b) arrangements are not subject to Title I of ERISA. While employer participation in the plan document process would be

beneficial, such participation will not be beneficial or welcome if it causes the 403(b) arrangement to become subject to Title I of ERISA.

### III. BACKGROUND

#### A. History of 403(b) Arrangements

##### 1. The Revenue Act of 1942

In 1942, Congress introduced a mechanism to assist tax-exempt organizations in competing with other employers for the services of employees. The mechanism permitted employees of tax-exempt organizations to save more easily for their retirement. The Revenue Act of 1942 (the “1942 Act”) added Section 22(b)(2)(B) to the Internal Revenue Code (the “Code”)<sup>8</sup> which permitted tax sheltered annuities (“TSA”) for employees of certain tax-exempt organizations. This Section provided an exception from the general rule on taxation of annuities<sup>9</sup> whereby, if an annuity was purchased for an employee by a tax-exempt organization, and the annuity satisfied the 1942 Act’s requirements for pension trusts, funds contributed to the annuity contract were not treated as income of the employee until payment was received.<sup>10</sup> The exemption, however, did not apply to salary reduction contributions.<sup>11</sup>

Section 22(b)(2)(B) did not place any limit on the percentage of compensation that could be contributed to the annuity,<sup>12</sup> and it was not uncommon during the 1950s for tax-exempt organizations to defer taxes on some employees’ entire salaries. In addition, issues arose under the 1942 Act as a result of regulations that imposed limits on contributions<sup>13</sup> and prohibited any form of salary reduction agreement between the employer and the employee.<sup>14</sup>

##### 2. The Technical Amendments Act of 1958

To address the issues that materialized under Section 22(b)(2)(B), Congress enacted the Technical Amendments Act of 1958 (the “1958 Act”). The 1958 Act further codified the tax deferred treatment and other benefits of annuities purchased by tax-exempt organizations by adding Section 403(b) to the Code.

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<sup>8</sup> 77-753, ch 619, 56 Stat. 798 (1942) (revised by the 1954 Code and codified in Section 72).

<sup>9</sup> Section 22(b)(2)(B) provided in relevant part:

If an annuity contract is purchased for an employee by an employer exempt under Section 101(6) [the current Section 501(c)(3)], the employee shall include in his income the amount received under such contract for the year received.

<sup>10</sup> Id.

<sup>11</sup> Rev. Rul. 54-267, 1954 WL 8327 (IRS RRU), 1954-2 C.B. 58.

<sup>12</sup> P.L. 77-753, ch 619, 56 Stat. 798 (1942).

<sup>13</sup> Treas. Reg. Section 1.403(a)-1(3).

<sup>14</sup> See Rev. Rul. 54-267. 1954.2 CS 58.

In the 1958 Act, Congress also imposed for the first time annual limits on the maximum amount that could be excluded from taxable income under TSAs. This was referred to as the “exclusion allowance.” Section 403(b)(2) limited the exclusion allowance for an employee to 20% of includable compensation multiplied by years of service with the employer, reduced by the total amount contributed by the employer for annuity contracts and excluded from an employee’s gross income in prior taxable years.<sup>15</sup> The reduction included not only amounts excluded under Section 403(b) but also amounts excluded by contribution to other pension-like programs.<sup>16</sup>

Among the other features of the 1958 Act was codification of the rule that annuities could not be directly purchased by an employee, but rather had to be purchased by an employer for an employee. Further, the 1958 Act codified eligibility requirements and prescribed that annuity contracts be both nontransferable<sup>17</sup> and nonforfeitable.<sup>18</sup> The 1958 Act also codified the availability of Section 403(b) to only employees of Section 501(c)(3) organizations.<sup>19</sup> Three years later, in 1961, the eligibility requirements were expanded to include employees of public educational, as well as Section 501(c)(3), institutions.<sup>20</sup>

### **3. ERISA and Changes Through 1985**

In 1974, Congress enacted the Employee Retirement Income Security Act (“ERISA”) which imposed additional limits on most TSAs and other funding vehicles for 403(b) arrangements, as well as all other pension plans. The requirements of Title I of ERISA were imposed on all 403(b) arrangements other than ones maintained by church<sup>21</sup> or governmental entities. They were still subject to most of the Internal Revenue Code provisions added by Title II of ERISA. By regulation, the DOL also exempted from Title I of ERISA 403(b) arrangements in which the employer’s involvement is essentially limited to making information available concerning insurance company and/or mutual fund products, withholding salary reduction contributions, and forwarding the contributions to the applicable funding agent.<sup>22</sup> The Title I requirements which are exempted by this

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<sup>15</sup> Code Section 403(b)(2) (repealed 2001).

<sup>16</sup> This includes contributions to qualified annuity plans, pension plans, bond purchase, and state retirement systems. Rev. Rul. 66-312, 1966-2 CB 127; IRS Rev. Rul. 79-221, 1979-2 CB 188.

<sup>17</sup> Treas. Reg. Section 1.401-9.

<sup>18</sup> Code Section 403(b)(1)(C).

<sup>19</sup> In its prior incarnation under the 1942 Act, TSAs were made available to individuals employed by organizations exempt under Section 101 (the predecessor to Section 501(c)(3)). Section 22(b)(2)(B), 56 Stat. 798 (1942).

<sup>20</sup> To qualify for 501(c)(3) status, an organization must be tax-exempt under Section 501(a). Public schools, however, are tax-exempt as political subdivisions of state governments, not under Section 501(a). Section 403(b)(1)(A)(ii).

<sup>21</sup> A church organization that maintains any church plan may make an irrevocable election under Code Section 410(d) that subjects it to the requirements of ERISA.

<sup>22</sup> DOL Reg. Section 2510.3-2(f) provides:

- (f) Tax sheltered annuities. For the purpose of Title I of the Act and this chapter, a program for the purchase of an annuity contract or the establishment of a custodial account described in Section 403(b) of the Internal Revenue Code of 1954 (the Code), pursuant to salary reduction agreements or agreements to forego an increase in salary, which meets the requirements of 26

CFR 1.403(b)-1(b)(3) shall not be "established or maintained by an employer" as that phrase is used in the definition of the terms "employee pension benefit plan" and "pension plan" if

- (1) Participation is completely voluntary for employees;
- (2) All rights under the annuity contract or custodial account are enforceable solely by the employee, by a beneficiary of such employee, or by any authorized representative of such employee or beneficiary;
- (3) The sole involvement of the employer, other than pursuant to paragraph (f)(2) of this section, is limited to any of the following:
  - (i) Permitting annuity contractors (which term shall include any agent or broker who offers annuity contracts or who makes available custodial accounts within the meaning of Section 403(b)(7) of the Code) to publicize their products to employees,
  - (ii) Requesting information concerning proposed funding media, products or annuity contractors;
  - (iii) Summarizing or otherwise compiling the information provided with respect to the proposed funding media or products which are made available, or the annuity contractors whose services are provided, in order to facilitate review and analysis by the employees;
  - (iv) Collecting annuity or custodial account considerations as required by salary reduction agreements or by agreements to forego salary increases, remitting such considerations to annuity contractors and maintaining records of such considerations;
  - (v) Holding in the employer's name one or more group annuity contracts covering its employees;
  - (vi) Before February 7, 1978, to have limited the funding media or products available to employees, or the annuity contractors who could approach employees, to those which, in the judgment of the employer, afforded employees appropriate investment opportunities; or
  - (vii) After February 6, 1978, limiting the funding media or products available to employees, or the annuity contractors who may approach employees, to a number and selection which is designed to afford employees a reasonable choice in light of all relevant circumstances.  
Relevant circumstances may include, but would not necessarily be limited to, the following types of factors:
    - (A) The number of employees affected,
    - (B) The number of contractors who have indicated interest in approaching employees,
    - (C) The variety of available products,
    - (D) The terms of the available arrangements,
    - (E) The administrative burdens and costs to the employer, and



regulation include the eligibility, reporting and disclosure, fiduciary (including a requirement to maintain a written plan document<sup>23</sup>), and vesting standards of Title I of ERISA. Prior to the proposed new Section 403(b) regulations, the IRS had never asserted an obligation to have a plan document or other plan writing (beyond the need for an annuity contract or a custodial agreement),<sup>24</sup> Therefore, the written plan requirement existed only for plans subject to ERISA.

Title II of ERISA imposed on Section 403(b) arrangements the maximum contribution limits of Code Section 415(c), in addition to the exclusion allowance. Code Section 415(c) placed limits similar to those imposed on qualified plans, but permitted additional flexibility to assist employees of tax-exempt entities who contributed little in the early years of employment by allowing them to contribute larger amounts in years nearer to retirement. It did this by providing three alternative catch-up provisions for older employees of tax-exempt educational institutions, hospitals, home health service agencies, certain church organizations, and health and welfare organizations.<sup>25</sup>

Title II of ERISA also provided new flexibility for Section 403(b) arrangements by permitting an alternative form of funding vehicle. Title II added Section 403(b)(7) which for the first time permitted 403(b) assets to be invested not only in TSAs, but also in custodial accounts that hold regulated investment company stock (generally mutual fund shares). The definition of a custodial account was expanded in 1976 to allow investment in closed-end investment companies that issue non-redeemable shares.<sup>26</sup> However, Section 403(b)(7) placed additional limits on custodial account investments by prohibiting employees from receiving distributions before age 59 from a custodial account that qualifies under Section 403(b).<sup>27</sup>

In 1982, a third alternative funding vehicle for 403(b) arrangements was added, but only for certain church employees. The Tax Equity and Fiscal Responsibility Act ("TEFRA") added Section 403(b)(9) to the Code. It provided for the use of retirement income accounts by a church, a convention or association of churches, or a related organization

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- (F) The possible interference with employee performance resulting from direct solicitation by contractors; and
  - (4) The employer receives no direct or indirect consideration or compensation in cash or otherwise other than reasonable compensation to cover expenses properly and actually incurred by such employer in the performance of the employer's duties pursuant to the salary reduction agreements or agreements to forego salary increases described in this paragraph (f) of this section.

<sup>23</sup> See ERISA Section 402(a)(i), which requires every employee benefit plan to be established and maintained pursuant to a written instrument.

<sup>24</sup> Code Sections 415(c)(4)(A), 415(c)(4)(B), 415(c)(4)(C).

<sup>25</sup> Code Section 415(c)(4).

<sup>26</sup> David A Pratt, *Very Serious Business: Sense and Nonsense Under Section 403(b) of the Internal Revenue Code of 1985*, 59 Alb. L. Rev. 1197, 1220 (1996).

<sup>27</sup> Code Section 403(b)(7)(A)(ii).

principally engaged in the administration or funding of a plan or program for the provision of retirement benefits and/or welfare benefits for the employees of a church or a convention or association of churches.<sup>28</sup> A retirement income account may offer Section 403(b) annuity contracts, Section 403(b) custodial contracts, or any other investment vehicle. Unlike Section 403(b) custodial accounts, retirement income accounts are not required to be held by any particular type of custodian, or invested in any particular manner.

Certain other arrangements were formally recognized as tax-deferred annuities by the IRS, but only temporarily. These arrangements include nontransferable interests in public retirement accounts and funded retirement reserves established by a tax-exempt employer.<sup>29</sup> Reasoning that the enactment of Section 403(b)(7) evidenced a Congressional intent to limit Section 403(b) to insurance contracts and custodial accounts (and later retirement income accounts), in 1982 the IRS reversed its position that these types of arrangements were eligible under Section 403(b). These arrangements are now only recognized as tax-deferred annuities if established prior to May 17, 1982.

#### **4. The Tax Reform Act of 1986**

The Tax Reform Act of 1986 ("TRA 1986") ushered in a third era of Section 403(b) regulation. TRA 1986 introduced additional limits on the amount permitted to be contributed by salary reduction to 403(b) arrangements. Code Section 402(g) limited the amount to \$9,500, subject to annual cost of living increases, plus limited catch-up contributions in certain situations. Amounts of salary reduction contributions in excess of the annual limit are not eligible for deferred tax treatment. Instead, excess amounts are included in the employee's gross income for the year in which the reduction was made, and they are taxed again when actually distributed.

Prior to 1989, 403(b) arrangements were not subject to the nondiscrimination rules applicable to qualified pension, profit sharing, and stock bonus plans. Without the encumbrances of the nondiscrimination rules, employers sponsoring 403(b) arrangements were able to provide participation in 403(b) arrangements to select individuals or classes of employees. However, TRA of 1986 added Section 403(b)(12) which extended to most 403(b) arrangements many of the nondiscrimination rules that apply to Section 401(a) qualified plans.<sup>30</sup>

Nondiscrimination rules were originally set to apply to plan years beginning after January 1, 1989. However, because of delays in finalizing the IRS regulations governing the nondiscrimination requirements applicable to qualified plans, full compliance with many of the nondiscrimination rules concerning contributions (other than salary reduction agreements) was not required until 1997 for tax-exempt employers and 1999 for

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<sup>28</sup> Code Sections 403(b)(9)(B) and 414(e)(3)(A).

<sup>29</sup> Rev. Rul. 67-387, 1967-2 C.B. 153.

<sup>30</sup> Section 403(b) employers that are government units are deemed to satisfy or are exempt from most of the nondiscrimination requirements. Section 403(b) employers that are churches or church-controlled organizations, as described in Code Section 3121(w)(3), remain exempt from the nondiscrimination rules. Code Section 401(a)(5)(G).

governmental employers and non-electing 414(e) church plans. In addition, Section 403(b) arrangements were permitted to take advantage of the safe harbor rules of IRS Notice 89-23.

Different nondiscrimination rules operate with respect to contributions made pursuant to salary reduction agreements for 403(b) arrangements than to all other types of plans. For salary reduction agreements for 403(b) arrangements, the so-called universal availability requirement of Section 403(b)(12) requires that, if a plan provides any salary reduction right, it must be made available to all employees willing to contribute more than \$200 per year.<sup>31</sup> This is very different from the nondiscrimination rules that apply to Section 401(k) salary reduction contributions, including the average deferral percentage test (which does not apply to 403(b) arrangements).

Before the Tax Reform Acts of 1984 and 1986, the distribution rules for 403(b) arrangements were limited. The 1984 and 1986 Tax Reform Acts added sections requiring that amounts accumulated in 403(b) arrangements after 1986 be distributed according to rules similar to the Section 401(a)(9) rules for qualified plans.<sup>32</sup> The IRS first released proposed regulations for minimum required distributions in 1987 and then issued revised guidance in 2001 and 2002. The 2002 temporary rules were adopted in final form in 2004. The final rules direct that distributions for amounts accumulated after 1986 must begin on April 1 of the later of the year after the participant reaches age 70-1/2 or the year after the participant retires.

Amounts accumulated before 1987 are afforded grandfather status under which they are to be distributed in accordance with the minimum distribution incidental benefit rules set forth in regulations. The IRS had interpreted the incidental benefit rules as requiring that payment from 403(b) arrangements commence no later than when the participant reaches age 75, regardless of whether the individual is retired or an active employee.<sup>33</sup> Some commentators have suggested that it is no longer the IRS's position that distribution must commence for active employees by such date.<sup>34</sup>

## 5. EGTRRA

Section 403(b) contribution limits underwent a further significant reform with the passage of the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") in 2001.

EGTRRA repealed the Section 403(b)(2) exclusion allowance in place since 1958, eliminated the Section 415(c)(4) alternative catch-up limits, and added a new catch-up right.<sup>35</sup> As a result of these changes, contribution limits for 403(b) arrangements are now

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<sup>31</sup> Code Section 403(b)(12)(A)(ii).

<sup>32</sup> Code Section 403(b)(10); See Code Section 401(a)(9).

<sup>33</sup> IRS Ltr Rut 9345044.

<sup>34</sup> Donald R. Levy, Et. AL, 403(e) Answer Book (Sixth Edition). 10:18 (Aspen Publication, 2006)

<sup>35</sup> P.L. 107-16, Sections 631, 632.

essentially the same as those that apply to qualified plans, albeit based on a different definition of compensation.<sup>36</sup>

EGTRRA also introduced more liberal rollover procedures for participants in 403(b) arrangements. Prior to 2001, a participant could only roll over a distribution amount from a 403(b) arrangement to an eligible retirement plan that was either another Section 403(b) plan or an Individual Retirement Account qualified under Section 408(a) or 408(b).<sup>37</sup> Under EGTRRA, participants may also roll over a distribution received after 2001 into a qualified plan under Section 401(a), a qualified annuity under Section 403(a), or a government Section 457(b) plan that agrees to separately account for amounts rolled over from other types of arrangements.<sup>38</sup>

## **B. The 403(b) Market**

From a market perspective, investment providers and consultants have viewed the Section 403(b) universe as being composed of six distinct segments: public K-12 schools; public higher education; private K-12 (both church and non-church affiliated schools); private higher education; health care; and charitable, religious and other organizations. By arrangement count, the public K-12 market is the largest of the market segments. However, as measured by asset value, the private higher education market is the largest. Each market segment has unique characteristics, in large part caused by differences in the culture, history, and financial profile of the organizations which sponsor the plans. The market segmentation has been reinforced by investment vehicle providers that have tailored their marketing practices to accommodate these institutional differences. For instance, the public K-12 market is heavily weighted toward a salary reduction-only format, utilizing individual annuity contracts. Alternatively, employers in the health care industry tend to sponsor plans with employer contribution components, which are largely based on a group annuity platform.

As an overlay to the six market segments, 403(b) arrangements tend to be categorized as either subject to ERISA or exempt from ERISA. 403(b) arrangements sponsored by employers in the public K-12 segment and public higher education segment are generally exempt from ERISA coverage as governmental plans.<sup>39</sup> 403(b) arrangements sponsored by employers that are exempt from tax under Section 501(c)(3) and qualify as a church or are controlled by or associated with a church are exempt from ERISA as church plans.<sup>40</sup> Additionally, employers eligible to offer a 403(b) arrangement to their employees and who offer a salary reduction-only program with limited employer involvement often qualify for the regulatory exemption from ERISA.<sup>41</sup>

As a result of these three ERISA exemptions, a large number of 403(b) arrangements are exempt from the Form 5500 annual return requirement. Thus, reliable government

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<sup>36</sup> Beginning in 2002, the new catch-up limit, provided for in Section 414(v), applied to participants of 403(b) arrangements who are age 50 or more by the end of the plan year.

<sup>37</sup> Levy at Q 10:73.

<sup>38</sup> Code Sections 402(c)(8)(B) and 402 (c)(10).

<sup>39</sup> ERISA §3(32)

<sup>40</sup> ERISA §3(33)

<sup>41</sup> DOL Reg. §2510.3-2(f), supra note 19.

data regarding the nature and extent of 403(b) arrangements does not exist. However, for the past ten years, a private research consulting firm, Spectrem Group, based in Chicago, has compiled and analyzed detailed 403(b) market data. In 2004, Spectrem Group reported, among other things, that the 403(b) market was composed of approximately 58,000 eligible employers spread over the six distinct market segments. The following table shows the overall size of the market. Not surprisingly, large employers tend to be concentrated in the higher education and health care industries with smaller employers concentrated in the public and private K-12 segments. A high percentage of employers in the charitable, religious and other organizations category are small Section 501(c)(3) tax-exempt organizations with few employees.

**ELIGIBLE EMPLOYER DEMOGRAPHICS  
BY MARKET SEGMENT<sup>42</sup>**

Segment	Total Employers	Distribution by Number of Employees			
		<100	100-499	500-999	1000+
Public K-12	12,648	33%	46%	15%	6%
Private K-12	15,185	76%	16%	2%	6%
Higher Education (Public and Private)	5,660	14%	42%	18%	26%
Health Care	2,465	9%	37%	15%	39%
Charitable, Religious & Other	22,200	87%	10%	2%	2%
Total	58,158	49%	30%	10%	11%

Spectrem Group’s 2004 report also analyzed the dimensions of the 403(b) market in terms of numbers of plans and asset value. According to its research, the public K-12 segment maintained over 10,000 plans covering close to 2,000,000 participants but accounted for less than 25% of all invested 403(b) assets. This result is likely the product of a segment with a large number of salary reduction-only plans. Alternatively, the private higher education segment maintains approximately a quarter of the number of plans with approximately the same asset value as the K-12 segment. In this regard, the health care segment shares similarities with the private higher education segment.

**403(b) PLAN DEMOGRAPHICS  
BY MARKET SEGMENT<sup>43</sup>**

	Public K-12	Public Higher Ed	Private K-12	Private Higher Ed	Health Care	Charitable, Religious, and Other

<sup>42</sup> Market segment statistics utilized in this report are from the Spectrem Group report entitled “Marketing Retirement Plans to the Not-For-Profit Sector” dated December 9, 2004, and are used with its permission. The ACT is grateful for this contribution.

<sup>43</sup> “Marketing Retirement Plans to the Not-For-Profit Sector,” December 9, 2004, Spectrem Group.

	Public K-12	Public Higher Ed	Private K-12	Private Higher Ed	Health Care	Charitable, Religious, and Other
Plans (#)	10,580	1,160	4,900	2,480	1,960	3,125
% of total	44%	5%	20%	10%	8%	13%
Participants (000)	1,984	913	499	1,039	1,910	446
% of total	29%	13%	7%	15%	28%	7%
Assets (\$B)	\$147.8	\$100.5	\$41.3	\$150.7	\$110.6	\$22.4
% of total	26%	18%	7%	26%	19%	7%
Assets per Plan (\$MM)	\$13.7	\$86.6	\$8.6	\$60.8	\$56.3	\$14.5

The statistics also clearly demonstrate the differences across the six segments regarding the propensity of an employer to make contributions to 403(b) arrangements. As expected, a very small percentage of the total number of eligible employers in the public K-12 segment make employer contributions, while a much higher percentage of employers in the private higher education and health care segments make employer contributions.

#### EMPLOYER CONTRIBUTIONS BY MARKET SEGMENT<sup>44</sup>

	Public K-12	Public Higher Ed	Private K-12	Private Higher Ed	Health Care	Charitable, Religious, and Other
Employer Contributes	20%	38%	52%	78%	52%	65%

It should be noted that these organizations may also maintain 401(k) plans, and there are, in fact, a number of organizations eligible to establish 403(b) arrangements that instead establish 401(k) plans.

### C. Funding Structure

According to the Spectrem Group, total assets invested in 403(b) arrangements in 2004 amounted to approximately \$578 billion,<sup>45</sup> divided as follows: \$277 billion in fixed annuities (48%); \$191 billion in variable annuities (33%); and \$110 billion in non-variable mutual funds held in custodial accounts (19%). Mutual funds accounted for 19% of 403(b) assets in 2004, up from 17% in 1999.

Annuities are the prevalent investment vehicle in the 403(b) marketplace, no doubt because annuities were the first permitted investment options. Mutual funds and church related retirement income accounts were added later as permitted investment options.

<sup>44</sup> Id.

<sup>45</sup> For 2004, Investment Company Institute, a national association of U.S. investment companies, reported a slightly higher total asset value of \$585 billion.

Employers historically have followed one of two approaches with regard to the use of annuities. Employers have permitted either individual annuity contracts to be sold to their employees or they have utilized group annuity contracts. In the public K-12 segment, employers routinely permit multiple 403(b) vendors to offer their products to eligible employees. This is contrasted with the dynamics in the health care industry where the sponsors have taken a more managed, institutional approach to managing employee benefits by limiting the number of vendors but using group annuity contracts negotiated by the employer. As the following table describes, the percentage of employers using either single-provider, single record keeper,<sup>46</sup> or multiple providers is dramatically different across the six segments.

**FUNDING STRUCTURE DEMOGRAPHICS  
BY MARKET SEGMENT<sup>47</sup>**

	Public K-12	Public Higher Ed	Private K-12	Private Higher Ed	Health Care	Charitable, Religious, and Other
Purchasing Behavior						
Single Provider	15%	21%	61%	53%	46%	65%
Single Record Keeper	11%	11%	19%	10%	13%	10%
Multiple Providers	74%	67%	20%	37%	41%	25%

As noted above, many 403(b) arrangements are maintained with minimal involvement by the employer in order to satisfy DOL guidance, excluding such arrangements from Title I coverage. In other cases, the plan is exempt because of the nature of the sponsoring employer (a governmental or non-electing church plan). Because employers in such cases generally do not assume any fiduciary responsibility for the selection of investment options under the 403(b) arrangement, insurance companies and mutual fund vendors in such cases market directly to the individual employees.

As a result, employers in the non-ERISA market – whether pursuant to DOL guidance or because of the type of employer – have generally left to the vendors documentation and record keeping obligations for 403(b) arrangements. Some provisions are specifically required by the Code to be included in the funding medium documentation.<sup>48</sup> Until recently, record keeping and documentation in such a multi-vendor environment has been handled separately from vendor to vendor. As an additional complication, some of the Code’s distribution rules differ between annuity contracts and mutual fund custodial arrangements.

**D. Recent Changes in 403(b) Plan Requirements**

<sup>46</sup> The Single Record Keeper category consists of arrangements where a common remitter handles the record keeping for the 403(b) arrangement and allocates contributions to multiple investment managers selected by the plan sponsor.

<sup>47</sup> Spectrem Group.

<sup>48</sup> e.g. See Code Section 403(b)(1)(E).

On November 16, 2004, the IRS issued proposed regulations under Section 403(b) (69 FR 67075, corrected on December 21, 2004, at 69 FR 76422). These proposed regulations, the first comprehensive set of Section 403(b) regulations in 40 years, reflect the fact that 403(b) arrangements are moving closer in concept to qualified plans. The proposed regulations offer the most basic structural changes to the Section 403(b) rules since the first regulations were published in 1964.<sup>49</sup> Although the IRS has frequently provided guidance to reflect new rules and positions, the basic composition of the regulations had remained unchanged. In the interim, however, as noted in more detail earlier in this report,<sup>50</sup> significant alterations have been made to Section 403(b) via legislation. The intent of the 2004 proposed regulations is to reflect the developments that have occurred in the forty years preceding their publication.

Because a major effect of the legislative changes has been to diminish the extent to which the rules applicable to 403(b) arrangements differ from the rules applicable to 401(k) and 457(b) plans, the proposed regulations reflect the increasing similarity among the various types of qualified deferred compensation arrangements. The preamble to the proposed regulations observes that, since 1964, a number of revenue rulings, notices and other guidance issued to interpret Section 403(b) have become outdated as a result of changes in the law. Accordingly, the IRS notes in the preamble its anticipation that a number of revenue rulings, notices and other guidance under Section 403(b) will be superseded by the proposed regulations once they become final.<sup>51</sup>

Although, the new regulations are largely aimed at addressing the growing convergence of 403(b), 401(k) and 457(b) plans, the defining characteristics of 403(b) arrangements—concerning eligibility, funding, and distributions—are preserved.

Among the notable changes provided in the proposed regulations is the new requirement that a 403(b) arrangement be maintained pursuant to a written plan that sets forth all the material provisions of the arrangement, including eligibility, benefits, time and form of distribution, the various contracts available under the plan, and relevant limits.<sup>52</sup> The following table summarizes the provisions of Section 403(b) that, among others, will likely need to be addressed in a written 403(b) plan.

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<sup>49</sup> Prop. Treas. Regs. Section 1.403(b)-1 through 11, REG-155608-02, 69 Fed. Reg. 67075 (Nov. 16, 2004). The regulations were initially scheduled to take effect for plan years beginning after 2005, but the effective date has now been delayed until after 2006.

<sup>50</sup> See Section III A above.

<sup>51</sup> *Id.* at 67076.

<sup>52</sup> Prop. Treas. Reg. Section 1.403(b)-1 through 11, REC.1-155608-02, 69 Fed. Reg. 67077 (Nov. 16, 2004). Under the proposed regulations, the document requirement may be satisfied by using a number of different documents.



**SUMMARY OF PROVISIONS REQUIRED  
OF SECTION 403(b) ARRANGEMENTS**

Provision	Code Section	Description
Eligible Employer	§403(b)(1)(A)	References §501(c)(3), §170(b)(1) (A)(ii), and §414(e)(5)(A).
403(b) Requirement	§403(b)(1)(B)	Plan is not subject to §403(a)
Participation	§403(b)(12)(A)(i)	Plan must satisfy the nondiscrimination requirements of 410(b).
Includible Compensation	§403(b)(3)	Statutory definition applicable to §403(b) plans.
Nondiscrimination Requirements	§403(b)(12)(A)(i)	With respect to contributions not made pursuant to a salary reduction agreement, such plan meets the requirements of paragraphs (4), (5), (17), and (26) of section 401(a), section 401(m), and section 410(b) in the same manner as if such plan were described in section 401(a).
Contribution Limitation	§403(b)(1)	Contributions must not exceed the limitations set forth in §415.
	§402(g)	Limitation on elective deferrals.
Salary Reduction	§403(b)(1)(E)	In the case of a contract purchased under a salary reduction agreement, the contract meets the requirements of §401(a)(30).
	§403(b)(12)(A)(ii)	All employees of the organization may elect to have the employer make contributions of more than \$200 pursuant to a salary reduction agreement if any employee of the organization may elect to have the organization make contributions for such contracts pursuant to such agreement.
Funding Vehicle	§403(b)(1)(A)	Annuity contract.
	§403(b)(7)	Custodial account.
	§403(b)(9)	Retirement fund for church.
Vesting	§403(b)(1)(C)	Employee's rights are non-forfeitable.
Withdrawals	§403(b)(11)	Requirement that distributions not begin before age 59-1/2, severance from employment, death, or disability for contracts funded by salary reduction.
Minimum Distribution Requirements	§403(b)(10)	Distributions must comply with requirements of §401(a)(9) and §401(a)(31).
Multiple Contracts	§403(b)(5)	Multiple annuity contracts must be treated as a single contract.
Rollover Amounts	§403(b)(8)	Must comply with rules under §402 for tax free treatment.
Trustee-to-Trustee Transfers	§403(b)(13)	Requirements for direct trustee-to-trustee transfer to a defined benefit governmental plan in order to be excludible from income.

## **IV. SCOPE OF THE PROBLEM**

### **A. Employers and Participants Affected**

403(b) arrangements continue to be a very important component of the country's retirement plan system. It is estimated that there are currently more than 24,000 403(b) arrangements in existence, covering nearly 6.8 million employees. Over one-half trillion dollars of assets are held in 403(b) arrangements.

Historically, 403(b) arrangements have been subject to fewer statutory requirements than retirement plans governed under Section 401(a), and therefore, have been subject to less regulation and oversight. Over the past several years, however, Congress has applied to 403(b) arrangements many of the non-discrimination rules, contribution limits, and distribution parameters applicable to plans qualified under Section 401(a). The proposed regulations, when finalized, will be the culmination of this guidance. The written plan requirement imposed by these regulations becomes an important compliance tool. It provides employers with detailed guidance as to its obligations, while at the same time setting forth for plan participants a description of the rights and protections afforded to them under the law.

### **B. Preconceived Notions of 403(b) Requirements Based on History**

Perhaps the most difficult challenge facing the IRS with regard to the written plan requirement will be educating the various segments of the 403(b) market as to their responsibilities. Different segments of the 403(b) market enter into radically different types of 403(b) arrangements. The written plan requirement will vary depending upon the type of arrangement. For example, the public K-12 segment of the 403(b) market likely consists of a large number of salary reduction-only plans sponsored by employers with limited administrative capacity. Historically, many of the 403(b) arrangements in this segment of the market are purchased directly from the annuity contract or custodial account vendor with little or no involvement of the employer. The responsibility for the written plan for this segment, however, will now fall on the employer. The document requirement for this segment of the market and this type of arrangement will be substantially different than the requirement for a plan of a large health care institution subject to Title I of ERISA.

While many 403(b) arrangements currently operate with a written plan document, these documents have generally not been subject to IRS scrutiny for compliance with changes in law and regulation. They are generally written by vendors or attorneys in a good faith attempt to comply with the law. They, however, vary greatly in quality and completeness. This is vastly different than the 401(a) arena, where all documents generally are approved by the IRS. To help promote compliance with the written plan requirement contained in the regulations, the IRS should provide plan sponsors with tools and procedures similar to those offered to 401(a) plans.

### **C. The Written Plan Requirement and Title I of ERISA**

The requirement for a written plan raises concerns that nongovernmental, non-church, salary reduction-only 403(b) plans exempt from the requirements of Title I of ERISA under the DOL regulatory exemption will lose their ability to utilize this exemption. The preamble to the proposed regulations notes that the DOL has advised that, although it does not appear that the written plan requirement would necessarily cause a 403(b) salary deferral arrangement to become an “employee pension benefit plan” within the meaning of Title I of ERISA, it is possible that in establishing a plan document the employer may undertake responsibilities that would lead to coverage under Title I.<sup>53</sup> The Department of Labor further advised that it will analyze these matters on a case by case basis.<sup>54</sup>

The IRS and DOL are discussing these issues in connection with the final regulations with the intent that complying with the written plan requirement will not by itself result in loss of the regulatory exemption.<sup>55</sup>

### **D. Determination of the Adequacy of the Plan Document**

Although the proposed regulations will require written plans that satisfy the statutory and regulatory requirements, other than seeking a private letter ruling, there is currently no way for an employer adopting such documents to ensure that its plan complies, in form, with the rules. The option of adopting a pre-approved prototype 403(b) plan is not available.<sup>56</sup> Nor will the IRS issue determination letters covering individually designed 403(b) plans.<sup>57</sup>

The IRS does issue private letter rulings regarding 403(b) plans, but the process of obtaining a ruling for a 403(b) plan is more complicated and expensive than the process of obtaining a determination letter for a qualified plan. Also, a private letter ruling may not offer the scope of reliance of a determination letter. For example, if an employer requests a private letter ruling on limited issues in connection with a Section 403(b) plan, the letter will not provide the same scope of reliance as a determination letter issued for a qualified plan.<sup>58</sup> Even if a private letter ruling is obtained upon the adoption of a plan, they are rarely obtained as plans are amended and updated.

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<sup>53</sup> Prop. Regs. §1.403(b)-3(b)(3).

<sup>54</sup> *Id.*

<sup>55</sup> Prop. Treas. Regs. Section 1.403(b)-1 through 11, REG-155608-02, 69 Fed. Reg. 67082 (Nov. 16, 2004).

<sup>56</sup> Under section 6.03(6) of Rev. Proc. 2005-16, IRS opinion letters will not be issued for annuity contracts under section 403(b).

<sup>57</sup> See section 3.02(1) of Rev. Proc. 2005-6.

<sup>58</sup> See Announcement 2001-83.

## V. PROPOSAL/RECOMMENDATIONS

The ACT's proposals and recommendations are designed to achieve two objectives. The first and most obvious is to assist employers and other plan and contract sponsors of 403(b) arrangements in complying with the written document requirements anticipated to be imposed by the final 403(b) regulations. However, the ACT also believes that establishing pre-approved plan documents and procedures for IRS determination of the adequacy of individually designed plan documents will further the Commissioner of Internal Revenue's objectives of seeking compliance and enforcement.

As noted, at present there is no process for, nor any uniformity to, the documentation of 403(b) arrangements. By adopting the recommendations and proposals described herein, the ACT believes that the IRS will facilitate compliance with the documentation requirements. However, as also explained below, the creation of a pre-approved document program and procedures for IRS determination of plan documentation compliance does not assure that employers and other plan document sponsors operate 403(b) plans in accordance with the Code requirements.<sup>59</sup> Nevertheless, the ACT believes the recommendations contained in this report are a first step in overall compliance with the rules applicable to 403(b) arrangements.

In establishing these recommendations, the ACT sought to address the needs of the different groups of employers who maintain 403(b) arrangements. The six market segments described earlier in the report can be categorized into three groups of plan sponsors for purposes of our recommendations. These groups are as follows: (i) employers (a) that maintain plans which are not subject to ERISA (such as church plans and governmental plans<sup>60</sup>), or (b) that do not want to be treated as maintaining a plan that is subject to ERISA (i.e., employers who rely on the DOL regulations regarding 403(b) arrangements which are not deemed "established or maintained by an employer"); (ii) employers that maintain plans which are subject to ERISA and will be able to use pre-approved plans along the lines of the M&P or VS plans presently available for employers maintaining Section 401(a) qualified retirement plans; and (iii) employers that maintain plans which are subject to ERISA, but prefer to use individually-designed plan documents. As such, the ACT is proposing three different arrangements for these three different employer groups.

### A. Non-ERISA, Simplified Plan Document Program

As previously noted, many employers that are not subject to ERISA, such as small private K-12 church-affiliated schools and public K-12 schools,<sup>61</sup> as well as those employers who want to continue to rely on the DOL regulations to avoid being subject to

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<sup>59</sup> See the ACT's concerns discussed in B. below.

<sup>60</sup> ERISA §4(b)(1) &(2)

<sup>61</sup> Some of the employers that are not subject to ERISA because they maintain church plans or governmental plans, however, will want to use one of the other model arrangements described below.

ERISA, such as private K-12 non-church-affiliated schools, and certain charitable organizations, will not want to establish elaborate plan documents. For many, it will be because they do not want to provide for employer contributions, and for others it will be because they do not have the internal capability to manage an elaborate 403(b) program. This group of employers will likely be providing salary reduction-only arrangements for their employees. These arrangements have historically been detailed in annuity contracts and custodial agreements provided by vendors.

For this group of employers, the ACT recommends that the IRS create a simple salary reduction-only model document that “wraps around” the custodial and/or annuity contracts entered into with the 403(b) custodian or annuity provider. This simple “wrap around” plan document would contain those provisions that are required for 403(b) plans that would not normally be found in the custodial agreement or annuity contract.<sup>62</sup> This recommendation could be met with an IRS form, such as the 5305 series of forms, or could be met with a separate model document that the IRS develops.

Whichever format is chosen, however, the ACT recommends that it be coordinated with the DOL, so that the DOL is able to provide formal guidance similar to that provided with regard to automatic rollovers,<sup>63</sup> clarifying that the adoption of the model form by itself will not result in more employer involvement than is permissible under the DOL regulations to avoid exposing the plan to coverage under Title I of ERISA. The ACT believes such guidance is achievable, and we urge the IRS and the DOL to address this problem on a coordinated basis so that effective and timely guidance is issued.

## **B. Pre-Approved Plan Program**

### **1. Structure of the Current Pre-Approved Plan Program**

The IRS has maintained a pre-approved plan program for 401(a) plans for many years.<sup>64</sup> Initially, the program was limited to M&P plans but expanded in subsequent years to include VS plans.

M&P plans are comprised of a basic plan and adoption agreement and unless included in the basic plan document, a trust or custodial agreement document. The principal difference between master and prototype plans is that a master plan utilizes a single funding medium for all employers while a prototype plan utilizes separate funding medium for each adopting employer. Historically, financial institutions offering funding vehicles were the principal sponsor of M&P plans, but in recent years other constituents of the retirement plan community (e.g., third party administrators, employer associations, practitioners, etc.) also have sponsored these plans.

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<sup>62</sup> A sample model wrap-around document is included as Exhibit A as an example of how this could be reduced to a form.

<sup>63</sup> 29 CFR 2550.404a-2

<sup>64</sup>In Announcement 2004-3, the IRS reiterated its commitment to maintain its two components: a master and prototype program and a volume submitter program.

A VS plan is a plan adopted by an employer that is substantially similar to the specimen plan of a VS practitioner. The specimen document is typically a single integrated plan and trust instrument, but may take the form of an M&P plan by utilizing an adoption agreement and a separate plan/trust document. The principal difference between a VS plan and an M&P plan is the flexibility given to sponsors in designing options that may be available under the plan and to adopting employers who are permitted to customize plan features for their benefit and still remain in the pre-approved plan program. Historically, the program was designed to facilitate the plan qualification process for practitioners who submitted a large number of individually designed plans for determination requests which were substantially identical. In recent years, its use has been expanded to other constituents of the retirement plan community.<sup>65</sup>

The success of this program is validated by an estimate of the IRS that approximately 94% of all qualified retirement plans today utilize pre-approved plan documents. This program provides an attractive, low-cost alternative to individually designed plans for adopting employers seeking “document reliance.” Additionally, it provides vendors with an ancillary product/service that can be offered to their customers and utilized as a marketing tool. Finally, it provides the IRS with a method to review and approve many plan documents efficiently and with the smallest use of its own resources.

Currently, the operation of the pre-approved plan program for 401(a) plans is governed by Rev. Proc. 2005-16 and Rev. Proc. 2005-66. Rev. Proc. 2005-16 sets forth procedures for issuing opinion and advisory letters regarding the form of plan documents. It continues to recognize the separate character of the M&P plan and VS plan programs, although for the first time incorporating both programs in a single revenue procedure. Additionally, it recognizes a narrowing of the differences between the two programs.<sup>66</sup> Rev. Proc. 2005-66 outlines the procedures to be utilized by M&P and VS plans under the new staggered remedial amendment scheme. These include a description of the use of the annual cumulative list, requirements for interim amendments, projected deadlines for the adoption of plan amendments, and so forth.

## **2. Implementation of Its Recommendation**

To address the largest number of employers that are not maintaining salary reduction-only 403(b) plans, the ACT recommends that the IRS expand the scope of its existing M&P and, if appropriate, its existing VS programs,<sup>67</sup> to include 403(b) plans. As noted previously, the ACT strongly believes that the implementation of mechanisms whereby adopting employers can utilize and rely upon documents that are consistent with the requirements of Section 403(b) and published IRS guidance will facilitate overall plan compliance. Although the ACT expresses some reservation about the current pre-

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<sup>65</sup> Some vendors are reluctant to use these plans because of their desire to limit and control the variables made available to their customers, presumably for the purpose of facilitating plan administration.

<sup>66</sup> For example, the review of plan documents for both programs has been centralized in a single location and now both programs allow the use of cross-testing allocation methodologies.

<sup>67</sup> As noted earlier, the ACT is not confident that a VS program for 403(b) arrangements is necessary. See p. 6 of this report.

approved plan program,<sup>68</sup> it believes that the popularity and benefits enjoyed by the constituent members of the retirement plan community will readily expand into the 403(b) plan area.

The ACT further believes that this recommendation could be readily implemented by the IRS.<sup>69</sup> At this time, a pre-approved plan infrastructure is in place. With the issuance of expanded guidance and training of existing personnel, its pre-approved plan program could be expanded to include 403(b) plans. The following would be required:

(a) After issuance of the final 403(b) regulations, expanded LRMs<sup>70</sup> would need to be developed for use by plan sponsors. Many existing LRMs utilized by 401(a) plans would, of course, also be applicable. The ACT understands that the IRS has begun to develop plan language that implements portions of the proposed regulations and, as such, that language should be readily adaptable into LRM format.<sup>71</sup>

(b) Although the IRS has already designated and trained a group of its agents to review pre-approved 401(a) plans, further training will be required for reviewing 403(b) plans. Furthermore, it is not clear if additional staffing will be needed or whether existing staff may be utilized. The ACT is, however, cognizant of the contemplated “timeline” for processing pre-approved 401(a) plans under Rev. Proc. 2005-66 and its staggered remedial amendment cycles. The IRS anticipates that the review of all current pre-approved defined contributions plans will be completed by January 31, 2008.<sup>72</sup> At the completion of this assignment, many of those same agents, with appropriate training, could be assigned responsibility for reviewing 403(b) arrangements. Other than processing pre-approved defined benefit plans, which are on a different staggered remedial amendment cycle and will likely require a much smaller number of agents, those agents dedicated to processing pre-approved defined contribution plans would be assigned other responsibilities until the beginning of the next staggered remedial amendment cycle for pre-approved plans (2011-2013). The ACT believes that with the adoption of the written document requirement, many more plan sponsors will be submitting their plans for private letter rulings if there is not another process available to obtain IRS approval of the document. The ACT further believes that the creation of a document approval process will likely require less manpower than the resources necessary to address the inevitable expanded PLR requests if another approval alternative is not available.

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<sup>68</sup> See VII Other Considerations and Concerns.

<sup>69</sup> Since the 403(b) market is about 25% of the size of the 401(a) market, the ACT believes that there will be a great deal of consolidation of pre-approved documents. It anticipates that there will be less than 200 M&P documents submitted for approval.

<sup>70</sup> The IRS web site describes its Listing of Required Modifications (“LRMs”) as “a collection of information packages designed to assist sponsors who are drafting plans to confirm with applicable law and regulations.”

<sup>71</sup> The Employee Plans Division already is developing “model amendments for 403(b) plans similar to those provided in Rev. Proc. 2004-56 for use by state and local governments in meeting the plan document requirements specified in final § 457(b) regulations.

<sup>72</sup> The ACT recently learned the number of specimen plans submitted under Rev. Proc. 2005-66 was far less than anticipated and as of this date it is unclear whether this may have an impact on the published timeline.

(c) While the details of implementing this program exceed the scope of this recommendation, the Employee Plans Division would, however, need to consider such matters as:

- The necessity for national sponsor and mass submitter procedures.
- The latitude to be given to customizing loan, hardship withdrawal, rollover and minimum distribution rules.
- The latitude of plan sponsors in integrating annuity and custodial arrangements into single documents or separating documents and providing for the separate review of one or more annuity and/or custodial arrangements.<sup>73</sup>

Many 403(b) vendors already utilize “model” plans that looks very much like M&P or VS plans, but do not have IRS approval. Consequently, the ACT believes that it will be reasonably easy and highly desired for vendors to adapt to this program.

### **C. Individually-Designed Plan Approval Program**

Currently, if an employer wishes to obtain an IRS determination that a 403(b) document meets the requirements applicable to those plans, the employer must submit a request for a PLR.<sup>74</sup> However, the PLR process is cumbersome, uses national office resources and is expensive and time consuming for the employer sponsoring the individually-designed plan. While over the last few years, there have been few requests for PLRs for 403(b) plans, the ACT believes that was due in large part to the lack of any requirements regarding specific terms for these plans. The Act believes that with the publication of regulations setting forth specific plan requirements, more employers will choose to request determinations that their 403(b) plans meet the Code requirements.

Attorneys have suggested to the ACT that the individually-designed plan universe which would request PLRs could be 10,000 or more. As such, the ACT recommends that the IRS adopt a 403(b) determination letter process similar to the 401(a) determination letter process,<sup>75</sup> but that, at this time, the process be limited to a determination regarding the terms of the plan and not include non-discrimination determinations such as are currently available under the 401(a) determination letter process.

The ACT believes that while the limited determination letter program is in effect, sponsors of 403(b) arrangements should continue to have the right to obtain private letter rulings with respect to issues that cannot be addressed through the limited determination letter program. However, plan sponsors should be required to obtain a determination letter prior to requesting a private letter ruling.

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<sup>73</sup> This is similar to procedures now available to plans under §4.04 of Rev. Proc. 2005-66 for obtaining a review of multiple trust agreements in conjunction with a plan review.

<sup>74</sup> See Rev. Proc. 2006-4, 2006-1 I.R.B. 135

<sup>75</sup> See Rev. Proc. 2006-6, 2006-1 I.R.B. 204; see also Rev. Proc. 2005-66, 2005-37 I.R.B.509



## VI. ADDITIONAL CONSIDERATIONS AND CONCERNS

### A. Concerns Regarding the Use of Pre-Approved Plans

The ACT's recommendation to expand the pre-approved plan program to include 403(b) arrangements is intended to further comply with the Code and updated regulations, but the ACT acknowledges that it will not address certain compliance problems. The dramatic proliferation of the use of pre-approved plans by smaller employers has been noted in prior ACT reports.<sup>76</sup> These same reports also have noted the ACT's concerns over systemic problems that are likely a by-product of this phenomenon.<sup>77</sup> Current members of the ACT continue to express their concerns over the many plan document preparation and plan operation/administration failures that appear to accompany the marketing and use of pre-approved plans by some vendors and practitioners in this market.<sup>78</sup>

In discussions with industry representatives and among ACT members, the ACT has observed and heard anecdotal evidence that:

- Despite the fact the IRS has pre-approved the form of a plan document, many plan document failures continue to occur because adoption agreements are:
  - i. not completed in their entirety;
  - ii. completed in internally inconsistent manner; or
  - iii. completed in a manner which unknowingly creates operational problems.<sup>79</sup>
- The administration of the plan is inconsistent with the manner in which plan documents are prepared.
- Adopting employers often fail to maintain and/or are unable to locate complete sets of plan documents.

These same problems may be encountered by employers utilizing individually designed plans, but it is the belief (again, not by an empirical study) that these failures are more likely to occur when a pre-approved plan is present. Possible reasons for these occurrences include:

- Insufficient resources or personnel of adopting employers (generally, smaller employers) to maintain qualified retirement plans.

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<sup>76</sup> The First Report of the ACT—June 21, 2001, p. 23 and the Fourth Report of the ACT—June 8, 2005, p. 9.

<sup>77</sup> The First Report of the ACT—June 21, 2001, pp. 23 and 27, and Third Report of the ACT—June 9, 2004, p. 17.

<sup>78</sup> In a speech to the Benefits Conference of the South, TE/GE Commissioner Steve Miller expressed similar concerns: "Are participants including retirees getting the service they should from plan administrators? Also, as we see more and more adoption of mass marketed plans, how do we best police follow up compliance in such plans?"

<http://www.irs.gov/retirement/article/0%2C%2Cid=155424%2C00.html>.

<sup>79</sup> These include violations of § 411(d)(6), the failure to recognize commonly controlled businesses, discrimination in operation issues, etc.

- The failure of adopting employers to appreciate the complexity of the plans and the employer responsibilities inherent in maintaining these plans.
- The inherent conflict in the desire to expand the availability of retirement plans to more employees of smaller employers and the need to assure that the plan sponsors and other pre-approved plan program constituents comply with document/operational requirements.
- The failure of some constituents of the pre-approved plan program to take appropriate responsibility for document/operational failures.

As noted above, any serious consideration of the issues highlighted in this section of the report far exceeds the scope of this project. It is for this reason that the current members of the ACT suggest that the concerns described herein may be an appropriate topic for future ACT consideration.<sup>80</sup>

## **B. Determination Letter Program**

This report recommends that only a limited determination letter program be adopted for 403(b) arrangements out of respect for current limitations on IRS resources. The immediate problem facing sponsors of 403(b) arrangements is complying with a written plan requirement, and the limited determination letter program can address this need. The ACT believes, however, that a determination letter program for 403(b) arrangements similar to the program currently existing for plans enacted under Section 401(a) is a desirable goal. A full determination letter program should be considered as resources become available.

## **C. Model Amendments for 403(b) Custodial and Annuity Contracts**

The ACT suggests that the IRS consider publishing model amendments addressing the 403(b) written document requirements that should be included in the 403(b) custodial agreements and annuity contracts funding contributions to 403(b) plans. This recommendation would simplify the compliance process and assure uniformity and compliance with the requirements imposed on those contract providers. The ACT also believes model amendments would enhance compliance and would be an indirect form of enforcement of the rules applicable to those contract providers by correctly stating the requirements applicable to those providers in the operation of those contracts. The

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<sup>80</sup> Such a study might consider the following systemic changes:

- Increased responsibilities for document preparation and operational/administrative aspects of plans for vendors and practitioners who sponsor pre-approved plans.
- Utilization of ERPA's and other practitioners authorized to practice before the IRS to provide certifications concerning the adoption of pre-approved plans.
- Required "manuals" for the adoption of plan documents and the administration of plans by vendors and practitioners who sponsor pre-approved plans for adopting employers.
- The development by the IRS of checklists and other guidance expressly designed to assist adopters of pre-approved plans in document preparation and the operational/administrative aspects of their plans.
- Registration with the IRS upon adoption of a pre-approved plan.

ACT notes, however, that annuity contract language is generally subject to review and approval by state insurance departments.

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**Advisory Committee on  
Tax Exempt and Government Entities  
(ACT)**

**PUBLIC EMPLOYERS' TOOLKIT FOR  
PREPARING PAYROLLS**

**Nicholas C. Merrill, Jr., Project Leader  
Julian Regan, Project Leader**

June 7, 2006

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**TABLE OF CONTENTS**

I. EXECUTIVE SUMMARY ..... 3

II. INTRODUCTION ..... 4

III. BACKGROUND ..... 5

IV. SCOPE OF THE PROBLEM ..... 6

V. RECOMMENDATIONS ..... 7

VI. METHODOLOGY ..... 8

VII. APPENDIX (TOOLKIT & “WHERE TO FIND IT”) ..... 10

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## I. EXECUTIVE SUMMARY

The payroll preparation process for government employers has become increasingly more complex as new reporting and withholding requirements are legislated into the federal Internal Revenue Code (IRC), and state tax laws. The U.S. Census Bureau reports that there were 87,525 state and local government employers in March 2002, employing 18,349,000 workers, with payrolls amounting to \$52,323.5 million. It has been estimated that 20% of the American workforce is now employed by federal, state, or local governmental entities.

As has been noted in prior Internal Revenue Service (IRS) Advisory Committee on Tax Exempt and Government Entities (ACT) reports, public employers have long promoted voluntary compliance as the key to effective and efficient tax administration. Voluntary compliance by public employers requires not only executing specific withholding and reporting functions, but also includes identifying and eliminating barriers which prevent voluntary compliance.

The purpose of this project is to identify a mechanism, or mechanisms, which would allow units of state and local government to complete their payroll process in a more timely and accurate manner. In addition, the project will focus on compliance with existing tax code requirements.

The IRS Tax Exempt and Government Entities Division and its Federal, State, and Local Government (FSLG) component have previously acknowledged that public entity employers confront a unique set of payroll issues, as well as having to deal with those withholding and reporting problems faced by their private sector counterparts. The complexities of proper payroll preparation for public employers are increasing and will not simply go away.

### **Recommendations**

The ACT's recommendations are intended to be a practical and cost-effective approach to assisting governmental employers in the preparation of their payrolls using the various resources available to the IRS. According to the ACT's report, the IRS should:

- 1) Create a "Toolkit" on its website to assist Governmental Payroll Officers, which would centralize access to the various forms and publications necessary to properly complete their task;
- 2) Increase contact with the public sector employment community through informational seminars and targeted mailings; and
- 3) Make private letter ruling requests more affordable for governmental employers.

## II. INTRODUCTION

The Bureau of the Census has estimated that there were approximately 88,000 units of government in the United States in 2002. It has also been estimated that currently as many as one out of five (20%) employees in the United States works for a federal, state, or local unit of government.

Payroll preparation and the timely completion of various monthly, quarterly, and annual reporting documents are an integral part of the employment process. These reporting documents are required at the federal, state, and/or local level and can be quite complicated to prepare correctly. This project will focus, however, on the federal payroll reporting requirements under the Internal Revenue Code (IRC). The responsibility of overseeing compliance with these reporting requirements rests with the IRS. The IRS publishes forms and publications that are generally applicable to all employers, including both the private and public sectors. There are, however, situations which require unique withholding and reporting requirements involving governmental employers. Successfully identifying and dealing with these unique withholding and reporting differences for public sector employers forms the basis of the recommendations included in this project.

One area where such withholding and reporting differences have been an issue involves Social Security and Medicare Hospital Insurance (Medicare) taxes. Social Security and Medicare coverage and withholding requirements for state and local government employees can differ from those of employees in the private sector or the federal government.

Due to these potential withholding and reporting differences, the proper completion of state and local government payrolls can be a difficult and confusing task. Turnover among payroll officers and a lack of training regarding these withholding and reporting differences may exacerbate the issue and increase the instances of errors.

In addition to causing errors that could adversely impact employees, these difficulties can also lead to an increase in the examination cycle time for the IRS during the compliance check or audit of a particular governmental entity. "Examination cycle time" is the length of time spent, measured in days, by the IRS when performing payroll compliance checks or audits. The accurate completion of payroll records should reduce the IRS examination cycle time for this specific task.

### III. BACKGROUND

#### Social Security and Medicare Coverage - State and Local Government Employees

State and local government employees were excluded from Social Security coverage from 1935 (the date of the original Social Security Act) until 1950 because there was a legal question regarding the federal government's authority to tax state and local governments. Beginning in 1951, states and local governmental units were allowed to enter voluntary agreements with the federal government to provide Social Security coverage to their public employees. These agreements are called "Section 218 Agreements" because they are authorized by Section 218 of the Social Security Act (the "Act").

In 1939, the Old-Age, Survivors, and Disability Income (OASDI) program was created, and the funding mechanism for the Social Security program was officially established in the Internal Revenue Code as the Federal Insurance Contributions Act (FICA). The IRS is responsible for the collection of this tax.

All 50 states, Puerto Rico, the Virgin Islands, and approximately 60 interstate instrumentalities have entered into Section 218 Agreements with the Social Security Administration (SSA). Because of the voluntary nature of Section 218 Agreements, the extent of Social Security coverage varies from state to state, and from each government unit within those states. It is estimated that more than 6 million public employees are not covered for social security (i.e. "noncovered"), and the majority of these noncovered local government public employees are police, firefighters, and teachers.

Just over twenty years ago, the federal income tax code was amended through the Consolidated Omnibus Budget Reconciliation Act of 1985 (Pub. L. No. 99-272). This new provision resulted in mandatory Medicare coverage for state and local government employees hired (or rehired) after March 31, 1986, who were not already covered for full Social Security. "Full Social Security" as the term is used here means both the OASDI portion of the FICA tax, as well as the Medicare portion. Several years later another tax code amendment occurred which made Social Security coverage mandatory for state and local government employees who were not members of a public retirement system and who were not covered for full Social Security under a Section 218 Agreement. This law, the Omnibus Budget Reconciliation Act of 1990 (Pub. L. No. 101-508), became effective July 2, 1991. Specifically, these two income tax code changes managed to further complicated the payroll preparation process.

The IRS, in cooperation with the SSA and the National Conference of State Social Security Administrators (NCSSSA), combined their resources to create the Federal-State Reference Guide (IRS Publication 963). This comprehensive

document provides a rich history of the legislative and administrative background of Social Security and/or Medicare coverage for public employers. This was a substantial cooperative effort which resulted in the consolidation of information about the coverage differences in Social Security and/or Medicare between private and public employers. This current project, in part, intends to expand on the availability of online access to this publication, and other publications which would be helpful to governmental payroll preparers.

#### **IV. SCOPE OF THE PROBLEM**

##### **Variations in State and Local Government Employee Coverage**

There are several possible variations to the Social Security and/or Medicare coverage of a governmental employee. These variations depend upon the circumstances of their employment. It is possible that an employee could properly appear on the payroll in any one of the following coverage scenarios depending upon the employer's Section 218 Agreement (or lack thereof), the employee's position, date of hire and/or participation in an alternative retirement plan. Such an employee could be:

- a) subject to full Social Security coverage;
- b) subject to Medicare-only coverage;
- c) subject to no Medicare and no Social Security coverage; or
- d) subject to a minimum percentage of contributions to, or benefits from, a qualified retirement system.

There have been instances noted by the IRS during either a compliance examination or audit when employees have been miscoded on the payroll, and therefore, misreported to both the IRS and SSA. Previous reports of the Advisory Committee on Tax Exempt and Government Entities (ACT) have touched on this issue. TE/GE Education and Outreach (see June 21, 2002 ACT report), Gateway Opportunities: FSLG and Its Customers (see May 21, 2003 ACT report), and Barriers to Voluntary Compliance: Governmental Employers' Perspective (see June 9, 2004 ACT report), have all attempted to address one facet of the problem or another. As a result of the recent transition from education to compliance by the IRS, however it appears that withholding and reporting errors remain an issue that needs further clarification and training.

##### **Payroll Compliance Errors**

Payroll compliance errors can be a serious issue for public employees. These errors can lead to employees contributing to the federal Social Security and/or Medicare programs, having inaccurate wage and service credits posted to their accounts, and potentially receiving benefits to which they are not entitled.

Conversely, an employee could be miscoded on the payroll so as not to have Social Security and/or Medicare taxes deducted when they should have been covered. This employee would potentially never receive any benefits from SSA even though they should have been eligible to participate.

According to the IRS, during the first several years of its existence, the FSLG group was primarily focused on outreach and education of governmental customers. This focus has changed recently as the IRS has shifted its focus from that of education and outreach, to compliance. The IRS Federal, State and Local Governments Work Plan, dated October 1, 2005, includes the goals of expanding the compliance enforcement activity, understanding and improving compliance, and meeting customers needs to reach those goals. In FY 2004, outreach activities were reduced from 60% of available resources to 25%, and compliance activities increased from 40% to 75% of available resources. In FY2005, this ratio increased for compliance activities to 80% and in FY 2006, is expected to grow to 85% of available resources. Outreach efforts are expected to decline from 70% in FY 2005, and to 15% in FY 2006.

## **V. RECOMMENDATIONS**

The goals of: a) more accurate and timely processing of an entity's payroll; and b) increased compliance with the federal tax code, will have a direct benefit to the SSA and the IRS.

The goal of more accurate and timely payroll processing will provide for better reporting of employees' tax information to the IRS, and more precise communication to the SSA regarding eligibility for benefits.

The goal of increased payroll compliance should translate into more effective and efficient compliance checks and audits by the FSLG staff and management. The recommendations in this report are for increasing compliance in three major areas, each of which can have a measurable and useful benchmark.

### **Payroll Officer "Toolkit"/Alternative Sources of Information.**

The ACT recommends that FSLG prepare a "Toolkit" for its website which would be a valuable resource for new and existing payroll officers. This "Toolkit" would provide a single location on the IRS website for governmental employers to visit, which would provide assistance to a number of routine, as well as complex, tax withholding and reporting issues. The benefits to be derived from this website would be a much more focused, comprehensive, and easier to use information-gathering area for the users involved in the preparation of government payrolls.

The development of the "Toolkit" is not considered to be the final step in the compliance process, nor is it perceived to be the solution to all payroll withholding and reporting problems. It should, however, be considered as a significant step forward in addressing the accurate resource and educational needs of the public employer community as a whole. An explanation of what is included in this "Toolkit" is attached in the Appendix, as well as a reference guide for where to find the various government publications mentioned in this report.

### **Increased Contact with the Public Employer Community Through Informational Seminars.**

Many large public employers have the resources and knowledge base to identify a specific payroll problem and address it properly before the employee is paid, or to correct a situation shortly after it has occurred. This is not always the case, but generally is true. The dilemma is how to administer education and news updates to the smaller public employers who may not have as much institutional knowledge of these issues. Arranging for informational seminars with targeted mailings to a specific audience would assist in getting the message out to this particular stakeholder group.

Make private letter ruling requests more affordable to government employers. Government entities often have difficult employment tax questions which require the assistance of a professional attorney or certified public accountant. Government employers generally do not have a profit motive, and therefore, may have significant budgetary constraints regarding the high fees charged by the IRS for a private letter ruling. The IRS should consider a more reasonable fee structure to accommodate government employers who are interested in preparing accurate wage and tax reporting forms.

## **VI. METHODOLOGY**

- Issues related to state and local government payroll withholding for Social Security and Medicare coverage were identified, in part, through anecdotal customer feed back provided through the National Conference of State Social Security Administrators (NCSSSA). (One of the authors of this report, Nicholas Merrill, Jr., is a past President of and still current member of the NCSSSA.)
- Issues related to IRS Tax Exempt and Government Entities (TE/GE) examinations and compliance checks of state and local employers were identified in part through discussion with TE/GE senior staff and through customer feedback.
- Recommendations were based in part of the TE/GE Concept of Operation for FY 2006 which identified, among other objectives, a goal to improve

- the quality of customer contacts, particularly in light of an incremental reallocation of resources from outreach to enforcement activities.
- Data included in this report was derived from the FY 2006 FSLG Work Plan.
  - Methodology included ACT members' examination of employer educational resources inclusive of the Federal, State and Local Governments (FSLG) section of the IRS website and the Social Security Administration website for state and local government employers.
  - IRS senior staff provided FSLG ACT members with drafts of the Government Entity "Toolkit" on or about January 2006.
  - In the future, additional methods to assess the benefits of the "Toolkit" may include a future survey(s) of customer groups, including NCSSSA members.

## VII. APPENDIX

### Government Entity Toolkit

This Toolkit consists of two parts: (a) Public Employer's Toolkit which provides information to government entities and payroll officers working for government entities in meeting their federal employment tax obligations and (b) Government Entity Compliance Toolkit, which provides information to help government entities and their powers of attorney understand the enforcement process.

### Public Employer's Toolkit

If you are a new employer, or new to dealing with federal employment tax, the first place to go for information is IRS [Publication 15](#), Employer's Tax Guide (Circular E). This publication is revised each year and contains the basic information employers need to be able to collect adequate information so they can determine and pay their and their employees' portion of employment tax liability, file correct tax returns, and withhold federal taxes, where necessary.

You may also want to consult the following Publications that include information specific to government entities:

#### [Public Employer's Tax Guide](#)

[Publication 963](#), Federal-State Reference Guide

[Publication 15-A](#), Employer's Supplemental Tax Guide

[Publication 15-B](#), Employer's Guide to Fringe Benefits

The following list includes most federal tax forms and instructions you are likely to need to process payroll and file necessary returns with the IRS. You can download the forms and instructions from the links. Note: Some of the forms are information copies only and cannot be used for filing. A list of all IRS forms (in fillable format) and publications is available at <http://www.irs.gov/>.

- [Form SS-4](#), Application for Employer Identification Number ([with instructions](#)).
- [Form W-2](#), Wage and Tax Statement ([with instructions](#)). This form must be issued to recipients of wages and filed with the IRS.
- [Form W-3](#), Transmittal of Wage and Tax Statements. This form is used to transmit the Form W-2 to the IRS.
- [Form W-4](#), Employee's Withholding Allowance Certificate. This form must be furnished to each employee upon hiring to determine their correct withholding. The employee may submit new certificate at any time.



- [Form W-9](#), Request for Taxpayer Identification Number and Certification ([with instructions](#)).  
This form must be furnished to each person who receives a payment from a government entity in order to verify the recipient's taxpayer identification number. Examples of such payments are interest payments made by a government entity and payments made to persons who are not employees of the government entity.
- [Form 941](#), Employer's Quarterly Federal Tax Return ([with instructions](#)).  
This form must be filed each quarter by an employer, including a government entity, who pays wages during a calendar quarter.
- [Form 945](#), Annual Income Tax Withholding Return ([with instructions](#)).  
This form must be filed by each employer, including a government entity, to report withholding (including back up withholding) on payments other than wages. Examples of such payments made by a government entity are pensions, annuities, and IRAs.
- [Form 1099-MISC](#), Miscellaneous Income ([with instructions](#)).  
This form must be filed by any payer, including a government entity, who makes certain payments for services to recipients who are not employees.
- [Form 1096](#), Annual Summary and Transmittal of U.S. Information Returns.  
This form is used to transmit Form 1099-MISC to the IRS.

You may be required to provide the following non-tax forms to new employees. They are available from other federal agencies:

- [Form I-9](#), <http://uscis.gov/graphics/formsfee/forms/i-9.htm>, Employment Eligibility Verification. This form can be obtained from the U.S. Citizenship and Immigration Services.
- [Form SSA-1945](#), Statement Concerning Your Employment in a Job Not Covered by Social Security. This form can be obtained from the Social Security Administration.

For further on-line information about employer responsibilities, visit the web page for [Employment Taxes for Businesses](#).

### **Government Entity Compliance Toolkit**

The following information explains what a government entity can expect during a compliance check or an examination conducted by FSLG. It also provides information with regard to adequate record keeping by government entities,

disclosure constraints on the IRS and consent by government entities authorizing the IRS to disclose tax information to third parties.

- FSLG Compliance Program: Compliance Checks, Examinations, and the Difference Between Them – The purpose of a compliance check and an examination, and the difference between the two.
- What Occurs During a Compliance Check – What a government entity can expect during a compliance check, including the types of questions asked during a compliance check, the kinds of information requested, and possible outcomes of a compliance check. This also includes sample compliance check opening and closing letters, proforma information document requests, etc.
- What Occurs During an Examination – What a government entity can expect during an examination, including the types of questions asked during an examination, the kinds of information requested, and possible outcomes of an examination. This also includes sample examination opening and closing letters, pro forma information document requests, etc.
- Basic Recordkeeping for Employment Taxes and Information Return Reporting – Suggestions about methods for maintaining employment tax records and vendor information. This also details what records must be maintained by a government entity with respect to an employment tax exam.
- Disclosure Restrictions – Constraints on the IRS with regard to disclosure of tax information of a government entity to third parties. This also provides consent for disclosure to the IRS, including power of attorney provisions, third party contact procedures, etc.
- Appeals Process – Information about the IRS Appeals Office and procedure for requesting review by the Office of Appeals in case of an adverse determination made by FSLG after an examination.

Where To Find It	
Consult the publications cited as primary sources for each topic.	
For information on...	See...
Deposit rules	<a href="#">Publication 15</a> (Circular E)
Who is an employee?	<a href="#">Publication 15</a> (Circular E)
Withholding	<a href="#">Publication 15</a> (Circular E)

Information reporting	<a href="#">General Instructions for Forms 1099, 1098, 5498, and W-2G</a>
Filing requirements	<a href="#">Publication 15</a> (Circular E)
Characteristics of government entities	<a href="#">Publication 963, Federal-State Reference Guide</a>
Section 218 social security coverage	<a href="#">Public Employer's Tax Guide</a> <a href="#">Publication 963, Federal-State Reference Guide</a>
Public retirement systems (social security replacement plans)	<a href="#">Publication 963, Federal-State Reference Guide</a>
Nonqualified (section 457) retirement plans	<a href="#">Public Employer's Tax Guide</a> <a href="#">Publication 963, Federal-State Reference Guide</a> (includes Notice 2003-20)
Fee-based employees	<a href="#">Publication 963, Federal-State Reference Guide</a>
Medicare coverage	<a href="#">Publication 963, Federal-State Reference Guide</a>
Cafeteria plans	<a href="#">Publication 15-B, Employer's Guide to Fringe Benefits</a>
Sick pay	<a href="#">Publication 15-A, Employer's Supplemental Tax Guide</a>
Employee meals and lodging expenses	<a href="#">FSLG Taxable Fringe Benefits Guide</a> <a href="#">Publication 463, Travel, Entertainment, Gift and Car Expenses</a>
Employee use of employer vehicle	<a href="#">Publication 15-B, Employer's Guide to Fringe Benefits</a> <a href="#">FSLG Taxable Fringe Benefits Guide</a>
Wages and items included in compensation	<a href="#">Publication 15-B, Employer's Guide to Fringe Benefits</a> <a href="#">FSLG Taxable Fringe Benefits Guide</a>
Clothing and uniform allowances	<a href="#">Publication 15-B, Employer's Guide to Fringe Benefits</a> <a href="#">FSLG Taxable Fringe Benefits Guide</a>
Bonuses and supplemental pay	<a href="#">Publication 15</a> (Circular E)
Emergency workers	<a href="#">Publication 963, Federal-State Reference Guide</a>
Volunteers	<a href="#">Publication 963, Federal-State Reference Guide</a>

Accountable plans	<a href="#">Publication 15</a> (Circular E)
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**Advisory Committee on  
Tax Exempt and Government Entities  
(ACT)**

**EFFECT OF IRS AUDIT INFORMATION  
ON TAX EXEMPT BOND MARKET**

**Robert E. Donovan, Project Leader  
Maxwell D. Solet, Project Leader**

June 7, 2006

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**TABLE OF CONTENTS**

EXECUTIVE SUMMARY ..... 1

METHODOLOGY .....3

BACKGROUND .....4

DISCUSSION .....9

GOALS AND RECOMMENDATIONS..... 12

CONCLUSION..... 19

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## EXECUTIVE SUMMARY

This project considers the effect of information about Internal Revenue Service (IRS) audits of tax-exempt bond issues on the structuring of future bond issues and on the bond market. It arises from the perception that information about IRS audits and the audit program which reaches participants in the bond market – issuers, conduit borrowers, bond counsel, investment bankers, financial advisors, and investors – is frequently delayed, incomplete, and sometimes distorted. The results of such misinformation can include new transactions which repeat old mistakes, new transactions which are less beneficial because they are structured to avoid potential problems whose exact nature cannot be understood, inaccurate pricing of audited bonds in the secondary market and in valuations by institutional holders, and the creation of a “cloud” over broad sectors of the primary and secondary markets beyond what may be justified by actual risk.

To minimize such problems, the Tax-Exempt Bond audit program (TEB), and the IRS generally, should be guided by the following goals in the conduct of audits and in dealing with audit information.

First, early, accurate and complete information should be made available simultaneously to the entire bond community as to compliance problems identified in the context of particular audits. To implement this goal, the ACT:

1. encourages the IRS to seek legislative consideration of ways to amend existing rules which limit the disclosure of return information in order to allow IRS disclosure of Preliminary and Proposed Adverse Determination letters;
2. encourages the IRS to seek legislative authorization for disclosure of Preliminary and Proposed Adverse Determination letters in “sanitized” form, with identifying information redacted; and
3. endorses the disclosure of Preliminary and Proposed Adverse Determination letters by recipients and encourages members of the bond community to reach a consensus as to the importance of such disclosure.

Second, beyond the context of particular audits, the IRS should speak to the bond community in ways which promote tax law compliance while avoiding disruption of state, local and tribal governments or the bond market. To implement this goal, the ACT:

1. has recommended that TEB adopt an internal policy on media contacts and is pleased that TEB has established procedural rules for coordination of TEB-initiated media statements and for incoming media contacts;
2. recommends that TEB develop policies which will guide the substance of its public statements to the media and to industry groups both as to particular audits and as to reporting of new audit initiatives and the results of on-going and completed ones; and

3. urges that increased “soft guidance” by TEB as to compliance problems identified through the audit process be undertaken with heightened awareness of concerns in the bond community as to policy-making by audit challenge. New audit initiatives should be developed in consultation with the Office of Chief Counsel. Legal questions which arise in the context of audits should more readily be submitted to Chief Counsel for Technical Advice. Finally, in light of the special respect to be given to the sovereign entities which issue tax-exempt bonds, and the innocent nature of the bondholders who bear the financial burden of an adverse tax determination, TEB should continue to focus its audit challenges on the most serious instances of non-compliance.

## **METHODOLOGY**

This ACT project began with a review of published IRS materials as to the audit process with respect to tax-exempt bonds. Prior ACT Reports related to bond audits, outreach, and voluntary compliance were reviewed.

An initial outline of this report was circulated to and used as the basis for discussions with representatives of groups from various constituencies in the tax-exempt bond community. These included the Enforcement Subcommittee of the Tax-Exempt Finance Committee of the Tax Section of the American Bar Association (ABA), the Debt Committee of the Government Finance Officers Association (GFOA), the National Association of Bond Lawyers (NABL), the National Federation of Municipal Analysts (NFMA), The Bond Market Association (TBMA), the IRS Tax-Exempt Bond group (TEB) within its Tax Exempt/Government Entities division, as well as several individual tax controversy counsel. ACT members also met with disclosure counsel from the IRS Office of Chief Counsel and with representatives from the Office of Municipal Securities of the Securities and Exchange Commission.

Certain statistical information was assembled by TEB at the request of the ACT.

A draft of this report was reviewed by Lenor Scheffler, Indian Tribal Governments member of the ACT, and the final report reflects her helpful comments.

## BACKGROUND

### The Tax-Exempt Bond Market

The tax-exempt bond market involves the purchase and sale of debt obligations issued by states, cities, counties, Indian tribal governments and other governmental entities to finance roads, bridges, schools, sewer systems and other public projects as well as certain privately owned or used projects which can be financed with qualified private activity bonds, including facilities owned by charitable organizations, low-income rental housing, airports, solid waste disposal facilities and bonds issued for the purpose of making student loans and certain single family mortgages. Currently outstanding tax-exempt bonds exceed \$2.2 trillion<sup>1</sup> and comprise obligations of approximately 50,000 issuers.<sup>2</sup>

### Brief History of Tax-Exempt Bond Audit Program

Prior to 1993, the IRS had no systematic program for auditing tax-exempt bond issues. In 1993, the General Accounting Office (GAO, now the Government Accountability Office) published a report which criticized the lack of an audit program, noting that then current IRS practice relied on “voluntary compliance and the checks and balances provided by reviews of bond counsels at issuance.”<sup>3</sup>

In response to the GAO report, the IRS created a tax-exempt bond compliance program, including a program for examination of outstanding bond issues.<sup>4</sup> Under the reorganization mandated by the Internal Revenue Service Restructuring and Reform Act of 1998, the tax-exempt bond audit program became part of the IRS’ new “Tax Exempt/Government Entities” division. The Tax-Exempt Bond program (TEB) is located within the Government Entities group.

TEB currently has 74 employees, including support staff and management. During the fiscal year ended September 30, 2005, it closed 483 audits. As of March 31, 2006, there were 485 audits pending.

### Life Cycle of a Tax-Exempt Bond Audit

The Examination Procedures adopted by TEB, as set out in the Internal Revenue Manual,<sup>5</sup> treat the state, local or tribal government bond issuer as the “taxpayer,” even though it is the bondholder or mutual fund shareholder who is subject to tax in the event that the bonds are determined not to be tax-exempt and even though the governmental issuers are not themselves subject to federal income tax.

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<sup>1</sup> “Holders of Municipal Debt: 1996-2005”, The Bond Buyer (March 15, 2006), 7, citing Federal Reserve Board, Flow of Funds Accounts, Flows and Outstandings, Fourth Quarter 2005.

<sup>2</sup> The Bond Market Association, [www.investinginbonds.com](http://www.investinginbonds.com), “Bond Markets Defined, Municipal Securities Market.”

<sup>3</sup> General Accounting Office, “Improvements for More Effective Tax-Exempt Bond Oversight,” GAO/GCD-93-014 (May 10, 1993), 4.

<sup>4</sup> Announcement 93-92, 1993-24 I.R.B. 66.

<sup>5</sup> I.R.M. § 4.81.1.11 et seq.

An audit, or examination, commences with a letter to the bond issuer. Such letters now come in four alternative forms, reflecting the origin of the audit: (1) random audits, (2) project initiatives not involving an identified problem, (3) project initiatives involving a perceived problem area, and (4) audits focused on a perceived problem as to the particular bond issue. The initial letter typically is accompanied by an Information Document Request.

After reviewing documents, and after discussions with the issuer and with any third parties which have relevant information, including a conduit borrower, the TEB auditing agent may close the case with no change or may issue a "Preliminary Adverse Determination" letter. Prior to issuance of such letter, the agent may request Technical Advice from the Office of Chief Counsel when there is doubt as to questions of law. The bond issuer being audited also may ask the agent to request Technical Advice. If Technical Advice is requested, the issuer is given the opportunity to make a written submission outlining its position to the Office of Chief Counsel.

A Preliminary Adverse Determination represents TEB's conclusion that the bonds do not fully comply with the statutory requirements for tax-exemption. It is usually followed by negotiations between the issuer and TEB as to a possible closing agreement designed to maintain the tax-exempt status of the bonds notwithstanding the alleged noncompliance. A closing agreement typically requires a cash payment from the issuer, and perhaps other transaction participants, to the IRS. TEB has operated on the expectation that most audits involving a finding of noncompliance would be resolved by a closing agreement.

In the event that a case is not so resolved, TEB issues a "Proposed Adverse Determination" letter. Following such a letter, the issuer has the opportunity to go to the IRS Appeals Office to seek a separate review of the adverse determination or an alternative settlement. Absent an appeal, or following an unsuccessful appeal, TEB will seek to tax bondholders.

Historically, slightly over 50% of audits have been closed on a "no change" basis. Most of the remainder have been resolved by closing agreement.

### **Special Features of Bond Transactions as the Subject of Audit**

Tax-exempt bond audits differ from typical IRS audits in several respects. First, these are audits of state, local or tribal government entities, or instrumentalities thereof, which issue bonds on their behalf. The states are sovereign entities with separate rights under our federal system of government, which rights they share with their local governments. Federally-recognized Indian tribal governments have sovereign status and rights to self-government which are recognized by treaty, statute, and case law. This sovereignty has been thought to require a special respect and deference beyond that owed to an ordinary "taxpayer" under audit. The first IRS proposed audit guidelines for tax-exempt bonds began its discussion of goals stating, "The Tax-Exempt Bond Program will combine compliance initiatives with enforcement measures, while taking

into account the unique relationship between the federal government and state and local governments.”<sup>6</sup>

Second, tax-exempt bond audits involve securities which are traded over the counter in a very active primary and secondary public market. Therefore, a large universe of investors has an interest in the status and outcome of an IRS audit, since the tax-exemption is crucial to the value of such bonds, even though such investors are not participants in the audit. While there are other IRS audit settings which present similar circumstances, it is certainly not typical.

Third, as noted earlier, a tax-exempt bond audit focuses on the issuer of bonds, because it is the issuer which is most likely to have the information which confirms compliance or non-compliance with the tax law. However, the real party in interest, and real taxpayer, is the investor. To the extent there is non-compliance with the tax law, the financial burden of a determination that bonds are taxable falls on the investor, who in the ordinary circumstance played no role in the structuring or implementation of the transaction, no role in any non-compliance, and typically plays no role in the audit process.

### **Prior ACT Reports**

Prior ACT Reports have addressed tax-exempt bond audits. In 2002, in its report on voluntary correction programs, the ACT noted that “To date, the TEB clientele are not getting sufficient feedback from the audit process. The industry is not learning what types of problems commonly recur and therefore tax counsel are often unable to help guide issuers and issuers are often unaware of arrangements that may give rise to compliance problems.”<sup>7</sup> It recommended expanded outreach programs relating to common problems, stating:

As the Service uses both its audit program and expands the voluntary correction program, TEB should expand its outreach program to include further information as to the types of errors that it finds on a regular basis. We are aware that section 6103 imposes substantial limitations upon the ability to make information derived from audits available to the general public. However, we believe that some generalized information could be released, perhaps in a digest form or in the form of collected statistical information, and development of such a program should be considered to the extent consistent with taxpayer confidentiality. In addition, the Service should consider whether these items or others that show up regularly should give rise to additional regulations (where the law may not be clear), notices, IRS publications, or educational materials (where the law may be

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<sup>6</sup> Proposed Examination Guidelines, 7 (10) (15) 1.2, in Announcement 95-61, 1995-32 I.R.B. 54.

<sup>7</sup> Advisory Committee on Tax Exempt and Government Entities, “Voluntary Correction Programs,” June 21, 2002, p. IV-11.

clear — at least to the Service — but may need to be disseminated more thoroughly), and recycling into a self correction program (where the errors are common, but ought to be able to be discovered and corrected in some reasonable manner without Service intervention).<sup>8</sup>

In 2004, the ACT produced an extensive report on the audit process as related to tax-exempt bonds. The report noted concerns about bond market reaction to disclosures that particular bond issues were under audit, without discussing the impact of information as to subsequent audit developments.<sup>9</sup> It also recommended that TEB provide additional “soft guidance,” stating:

We believe that educating the issuer community to the types of errors found during examinations of tax-exempt bonds that have a positive impact on future errors by other issuers. We recommend TEB develop a “Top 10” listing (or similar title) detailing the nature of the errors encountered during tax-exempt bond examination to be used as a training tool for agents. This list can be incorporated into the CPE material published on the TEB web site thereby providing an education tool for the entire tax-exempt bond community.<sup>10</sup>

### **Information Sources as to Bond Audits**

Information as to bond audits may become known to persons not directly participating in the audit in several ways. First, audit participants may disclose information to the marketplace during the course of an audit, whether as part of a mandatory “material event” disclosure under SEC Rule 15c2-12 or otherwise. Such disclosure ordinarily is made by filing with each “nationally recognized municipal securities information repository” or “NRMSIR” and the appropriate “state information depository” or “SID.” Such disclosure may describe the information in summary fashion or in detail.

Second, information may be informally disclosed by audit participants, intentionally or inadvertently. Such information may be transferred and re-transferred by word of mouth and may or may not be identified and reported in the press. It should be noted that information about bond audits may legitimately reside with others in addition to the audited issuer. For example, the audit process may involve IRS or issuer contact with bond trustees, conduit borrowers, underwriters, and counsel. Such information may be complete or incomplete, its communication may be accurate or less than accurate, and its dissemination may be to the entire market or only to certain participants.

Third, the IRS sends inquiry letters to bondholders it is able to identify from public sources seeking to identify taxpayers with respect to bonds which may be challenged.

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<sup>8</sup> *Id.* at IV-16.

<sup>9</sup> Advisory Committee on Tax Exempt and Government Entities, “Audit Cycle Time and Communications: Employee Plans and Tax Exempt Bonds,” June 9, 2004, p. IV-18.

<sup>10</sup> *Id.* at IV-28.

Such letters are silent as to the nature of any potential challenge. This can occur at a relatively early stage in the audit.

Fourth, in some instances, the IRS, as a condition of a “closing agreement” entered into with an issuer to terminate an audit and preserve the tax-exemption of a bond issue, may require a public statement with respect to the settlement.

Fifth, without identifying particular audited bond issues, the IRS may discuss its current audit programs and areas of concern in statements to the press or in statements to industry groups, which frequently are reported in the press.

Press coverage of tax-exempt bond matters includes occasional reporting in the general national financial press, e.g., The Wall Street Journal, Barron's. In some instances, local press provides coverage, which is occasionally intensive, as to matters of local or regional importance. Of most significance is a widely read daily specialty press, including The Bond Buyer and the Bloomberg “wire service.” Less frequent but sometimes more detailed reporting can be found in the Tax Journal for Tax-Exempt Bonds and The Bond Lawyer, both published quarterly.



## DISCUSSION

The ACT is concerned that information about IRS tax-exempt bond audits and its audit program currently becomes available to members of the bond community — issuers, conduit borrowers, bond counsel, investment bankers, financial advisors, and investors — in a non-systematic way, such that it is frequently delayed, incomplete, and sometimes distorted. In addition, such information may become available to some interested persons and not to others. Finally, certain important information may never become available to non-participants at all. This non-systematic dispersal of information can create problems of several sorts.

### Structuring of Future Transactions

Every state or local bond transaction (with the relatively rare exception of bonds issued on a taxable basis) must be structured to ensure compliance with Sections 103 and 141-150 of the Internal Revenue Code of 1986, as amended. Experienced tax counsel, underwriters and financial advisors attempt to provide the best possible programmatic and financial results for bond issuers and conduit borrowers without incurring any significant risk that the bonds may be determined to be taxable. To do so, those structuring transactions seek to be aware of, and to avoid, techniques and arrangements which invite challenge under federal tax law. While no one welcomes an IRS challenge, this is of heightened concern in tax-exempt bond transactions because the bond market ordinarily requires a “clean” or “unqualified” opinion from bond counsel as to the tax-exemption of the bonds.<sup>11</sup>

The circulation of incomplete or distorted information as to problem areas identified in IRS audits could cause subsequent transactions to be structured in a manner which produces a less than optimal result for the issuer or conduit borrower because of concern about challenges which are not yet fully understood but which are thought to have been made as to bonds already under audit. On the other hand, delay in circulation of audit information, circulation of incomplete information, or the failure to circulate such information could result in the use of structures and arrangements which have already been challenged elsewhere. Indeed, such a lack of accurate information could allow the replication of transactions where the tax exemption of already outstanding bonds had been maintained after an audit only as a result of an undisclosed closing agreement and payment of a closing agreement amount to the IRS. This is not to say that bond counsel might not properly disagree with an IRS audit challenge and remain prepared nevertheless to deliver an unqualified opinion, but any decision to do so should not be made in the dark.

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<sup>11</sup> The industry standard for tax-exempt bond opinions, in recognition of the fact that there is a particular lack of judicial precedent in this area of tax law as well as a “significant and somewhat unique” body of precedential and non-precedential administrative guidance, states that “bond counsel may nonetheless give an unqualified opinion with respect to federal income tax matters if it is firmly convinced that, upon the consideration of the material facts and all of the relevant sources of applicable law on federal income tax matters described [in the text] below, the Supreme Court would reach the federal income tax conclusions stated in the opinion or the IRS would concur or acquiesce in the federal income tax conclusions stated in the opinion.” National Association of Bond Lawyers Committee on Opinions and Documents, “Model Bond Opinion Report,” February 14, 2003, at 8.

## Pricing of Bonds

The circulation of incomplete or distorted information about IRS audit challenges can have significant effects on bond pricing in several contexts.

First, in the primary market for new issues, information that the IRS has raised questions as to the tax-exemption of a bond issue may affect the price, and in effect the interest rate, with respect to bonds which are deemed to be similar. It can be argued that an adverse effect on pricing is an appropriate market response to an incremental risk as to the tax-exempt status of bonds. However, the “cloud” on the market will create an inappropriate distortion to the extent that incomplete or distorted information causes the cloud to overshadow a larger portion of the market than would be affected by accurate information. Thus, for example, if investors perceive only that the IRS is challenging solid waste disposal financings, that perception may drive up the cost of borrowing for a facility for processing municipal waste notwithstanding that the actual audit challenge may only relate to the status as waste of a particular variety of industrial refuse.

Second, the secondary market for previously issued bonds is also affected by partial or distorted information. This occurs in the same manner as described above in the case of information which creates a cloud over too broad a sector of the market. In addition, in the case of audit information with respect to a particular bond issue, that bond issue’s price or interest rate will be directly affected. To the extent that the information is delayed, inaccurate, or not uniformly disseminated, it will create distortions in pricing and inefficiency in the market.

Third, many tax-exempt bonds are held by mutual funds which are required under the securities laws to determine the value of their portfolio holdings on a daily basis in order to calculate the reported “net asset value” on the basis of which the fund’s shares are traded.<sup>12</sup>

There is little objective data as to the effect of audit information on the pricing of bonds beyond the anecdotal. What discussion there has been has focused almost exclusively on disclosure as to the mere occurrence of an audit, not as to any subsequent written adverse determination.

At an earlier point in the development of TEB’s audit program, the co-chairs of a working group on IRS audits formed by the Government Finance Officers Association (GFOA) Debt Committee wrote:

As a general matter. . . , it appears that the disclosure that a bond issue is under audit results in a significant adverse reaction by the market. For fixed-rate bonds, this has meant a reduction in the value of the bonds and certain investors immediately selling the bonds under audit. In the case of variable-rate bonds, audit disclosure has resulted in the

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<sup>12</sup> Rule 22c-1, promulgated under the Investment Company Act of 1940, as amended.

interest rates on the bonds increasing to rates nearly equal to those on taxable securities.<sup>13</sup>

An early attempt at statistical analysis, based upon audits disclosed between 1999 and 2001, found that variable rate issuers “face[d] substantially higher borrowing costs following audit announcements. In addition volume effects were observed which indicate a reduction in liquidity as the VRDOS [variable rate demand obligations] are put back to dealers.”<sup>14</sup> The author found insufficient data to support quantitative conclusions as to long-term fixed rate bonds, but wrote: “However, there is much qualitative information that supports the hypothesis that the announcement of an IRS tax audit leads to a reduction in liquidity for long-term, fixed rate bonds.”<sup>15</sup>

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<sup>13</sup> Rapaport, M. and Watkins, J.B., III, “What to Do When the IRS Audits Your Bonds,” Government Finance Review (August, 2001), 24, 25.

<sup>14</sup> “Secondary Market Effects of Municipal Bond Tax Audit Disclosure,” The Bond Market Association (August, 2002), 6.

<sup>15</sup> Id.

## GOALS AND RECOMMENDATIONS

The ACT believes that TEB, and the IRS generally, should be guided by the following goals in the conduct of audits and in dealing with audit information.

- 1. Early, accurate, and complete information should be made available simultaneously to the entire bond community as to compliance problems identified in the context of particular audits.**

This will ensure that issuers, conduit borrowers, and bond counsel can plan and structure other bond financings in the most effective manner without risking the tax-exempt status of the bonds. It will ensure that audited bonds are not overvalued by the market because of a lack of information as to the audit nor undervalued by the market because of misinformation. It will ensure that those who wish to buy or sell audited bonds are able to do so in reliance on accurate and complete information which is public in nature and so does not create securities law concerns in connection with such trading.

The ACT believes that a Preliminary Adverse Determination should represent the IRS' carefully considered conclusion that a particular practice identified by audit is not in compliance with the law governing the tax-exemption of the bonds,<sup>16</sup> and that, as such, it should be disclosed to the bond community.<sup>17</sup> The same conclusion applies to a subsequent Proposed Adverse Determination, if issued. Such disclosure should include not just the fact that an adverse determination has been made but the substance and basis for the adverse determination and might best be made by disclosure of the actual text.

The ACT considered possible ways this goal could be achieved.

### Disclosure to Bondholders

Notwithstanding its practice of treating the issuer of bonds as the "taxpayer" for purposes of its audit procedures, the IRS recognizes that the real party in interest in a tax-exempt bond audit is the person whose interest income would be subjected to tax, and TEB is able to disclose all information as to a bond audit to such taxpayers.<sup>18</sup> Further, based upon advice from the Office of Chief Counsel, TEB takes the position

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<sup>16</sup> To the extent that current practice falls short of that standard, TEB should take steps to ensure that it is satisfied. The issuer which is the subject of an audit should be informed of the auditor's concerns and specifically invited to provide a full response prior to issuance of a Preliminary Adverse Determination. TEB should seek Technical Advice from the Office of Chief Counsel whenever legal issues are unclear and should make clear to the issuer and its counsel that the issuer may request TEB to seek Technical Advice.

<sup>17</sup> While similar issues may be presented by the commencement of an audit, and much prior discussion has focused on the appropriateness of disclosure at the time a bond issue has been selected for audit, the ACT takes no position on that question here.

<sup>18</sup> Office of Chief Counsel, "Disclosure Guide for Tax-Exempt Bond Examinations," 8.

that mutual funds stand in the shoes of their shareholders for this purpose and may also receive full information as to tax-exempt bond audits without requiring authorization from the bond issuer on Form 8821.

While a more active and systematic process of disseminating audit information to such bondholders could be undertaken, the ACT concluded that such steps would not adequately respond to its concerns. Such disclosure would be of no benefit to unrelated issuers and conduit borrowers engaged in planning other transactions and would be of no benefit to investors. Further, such disclosure could be of limited value even to a holder of an audited bond since the disclosure might constitute “material nonpublic information” on the basis of which the holder arguably would be precluded from trading under the securities laws.<sup>19</sup>

### **IRS Disclosure to the Market**

The ACT considered whether the IRS itself could disclose adverse determinations, posting them for example with the NRMSIRs. ACT members met with representatives of the Office of Chief Counsel and TEB to discuss this possibility. While an argument might be made that the issuer-focused audits conducted by TEB, ordinarily prior to even identifying actual potential taxpayers, do not give rise to protected “return information” under the Code, it is the clear position of Chief Counsel that § 6103(a) precludes such disclosure.

Since direct disclosure by the IRS would appear to be the most effective way to provide audit information to the bond community, the ACT encourages the IRS to seek legislative consideration of ways in which § 6103 might be amended to allow such disclosure.

It should be noted that a similar recommendation, and fairly extensive discussion, was included in the 1993 GAO report on tax-exempt bond oversight.<sup>20</sup> Loosened disclosure limitations have also been discussed in the exempt organizations area, in recognition of the public nature of such activity, not unlike that of tax-exempt bonds.<sup>21</sup> Any such changes, however, would have to take into account legitimate expectations of privacy and confidentiality, particularly in the case of conduit borrowers.

### **IRS Disclosure of “Sanitized” Versions of Adverse Determinations**

The ACT considered whether the IRS could disclose “sanitized” versions of its Preliminary and Proposed Adverse Determination letters, much as is done with Private Letter Rulings, Technical Advice Memoranda, General Counsel Memoranda and Field Service Advice. However, case law establishes that information retains its status as

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<sup>19</sup> Section 10(b), Securities Exchange Act of 1934.

<sup>20</sup> General Accounting Office, “Improvements for More Effective Tax-Exempt Bond Oversight,” GAO/GCD-93-014 (May 10, 1993), 48-55.

<sup>21</sup> Joint Committee on Taxation Staff Report, “Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998, Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations” (January 28, 2000).

“return information” even if identifying information is deleted.<sup>22</sup> The “sanitized” disclosures described above occur only because they are specifically authorized under Code § 6110. While disclosure of “sanitized” versions of adverse determinations would not as effectively alert investors as to risks with respect to particular audited bond issues, it would alert other issuers to concerns which might affect the planning of subsequent transactions, and it would assist investors more generally in assessing the risks as to bonds they were considering for purchase or sale. Therefore, the ACT encourages the IRS also to seek legislative consideration of ways in which § 6110 might be amended to allow such disclosure.

### **Disclosure by Issuers/Borrowers**

The ACT considered extensively whether, in the absence of adequate procedures for disclosure by the IRS, responsibility for disclosure could be placed on the recipients of adverse written determinations: the issuers and, indirectly, conduit borrowers. Consideration was given to recommending that the IRS request the Securities and Exchange Commission to identify written adverse determinations as being per se “material events” affecting the tax-exempt status of the bonds under SEC Rule 15c2-12.

This proposal provoked a strong response from members of the bond community with whom ACT members discussed it. While investors generally favor disclosure, in virtually all contexts, other segments of the community, including issuers, counsel, and investment bankers, were divided in their response, with those opposing the proposal in some instances stating strong opposition.

The ACT is mindful of the fact that its role is to advise the IRS, not the SEC. Further, ACT members are not experts in the securities laws. More important, the goals of the ACT here are different, and broader, than those of the securities laws. While those laws are designed to protect investors in particular bond issues, and require determinations of “materiality” in that context, the ACT is concerned about the significance of audit information not only to holders of bonds which are undergoing an audit but also to other issuers and to investors who might be buying or selling bonds of a similar but perhaps not identical nature.

In that context, the ACT endorses the disclosure of Preliminary Adverse Determination and Proposed Adverse Determination letters by recipients and encourages members of the bond community to reach a consensus as to the importance of such disclosure.

Anecdotal evidence suggests that disclosure in the past has been inconsistent, and what disclosure has been made frequently has involved only the fact that a letter has been received coupled with the issuer’s expression of intention to contest it.

In a study done by TEB, at the request of the ACT, it appeared that, for the fiscal year ended September 30, 2005, there was some voluntary disclosure as to 41 out of 69 Preliminary and Proposed Adverse Determination letters issued. Thus, approximately

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<sup>22</sup> Church of Scientology of California v. IRS, 484 US 9 (1987).

40% were not disclosed. The disclosure which was made frequently covered only the fact of issuance of a letter but sometimes discussed the substance of the letter as well.

Securities lawyers emphasize that “materiality”, which is a condition for mandatory disclosure under the securities laws,<sup>23</sup> is dependent on the facts and circumstances. For that reason, the SEC historically has not articulated per se rules as to materiality. However, senior SEC officials have begun to articulate their individual views as to the disclosure of IRS adverse determination letters. In a speech to the National Association of Bond Lawyers’ (NABL) Bond Attorneys Workshop, SEC Commissioner Roel C. Campos urged such disclosure:

Investors should feel confident that issuers will promptly file material event notices covered by continuing disclosure agreements without quibbling about whether or not the facts “should” be material to investors in the face of insistence by investors that they are. For example, investors have made it clear that they consider the issuance of proposed adverse determination letters by the IRS to be of great significance. You undermine investor confidence by keeping them in the dark for months while negotiating with the IRS and taking appeals.<sup>24</sup>

Speaking at a subsequent NABL event, Martha Haines, Chief of the SEC’s Office of Municipal Securities, discussing Preliminary and Proposed Adverse Determination letters, stated:

... the market price of bonds reacts when such news reaches investors -- demonstrating its real world materiality. I believe that issuers who deny investors such information are taking a foolish risk.<sup>25</sup>

It should be noted that even those who have opposed any expansion of mandatory disclosure have generally favored full and effective voluntary disclosure of material information and in some instances have encouraged development of pro-active investor relations policies.

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<sup>23</sup> It should be noted that the securities laws do not impose an obligation of disclosure on all bonds. Rule 15c2-12, which imposes the obligation on underwriters, not issuers, requires continuing disclosure as to, *inter alia*, “adverse tax opinion or events affecting the tax-exempt status of the security” if material. However, Rule 15c2-12 specifically excludes certain large denomination variable rate demand bonds, which make up a significant portion of tax-exempt bond issuances. In instances where there is no continuing disclosure obligation under Rule 15c2-12, disclosure of material events is likely required only in order to make other disclosures not incomplete.

<sup>24</sup> Roel C. Campos, “Keynote Address before the 30<sup>th</sup> Bond Attorneys Workshop of the National Association of Bond Lawyers,” (September 15, 2005).

<sup>25</sup> Martha Mahan Haines, “Remarks to 2006 NABL Tax and Securities Law Conference” (February 23, 2006).

The ACT suggests that a consistent practice of timely and complete disclosure of written adverse determinations might allay some concerns expressed to date and even improve the audit process for issuers. First, the perceived stigma arising from such disclosures may well be lessened substantially as disclosures become common, and thus no longer so newsworthy. Second, the likelihood of disclosure may cause TEB to exercise more and more diligence to ensure that its written adverse determinations are factually accurate and analytically sound.

**2. The IRS should speak to the bond community in ways which promote tax law compliance while avoiding disruption of the activity of state, local and tribal governments or the bond market.**

The IRS can and should communicate to the bond community information about the evolving focus of its audit program and the results of its audit initiatives. As indicated earlier, prior ACT reports have emphasized this need. However, such general communications need to be undertaken in a systematic manner which recognizes and successfully resolves certain real tensions. On the one hand, the bond community needs early warning as to potential problem areas in order to promote voluntary compliance. The bond market, and the press, also have a voracious appetite for information. In addition, the IRS has a natural desire to use the press and other public forums as a “bully pulpit” to promote compliance. On the other hand, care must be taken to avoid incomplete information. Further, care must be taken to avoid premature identification of what may be only potential problems in ways which result in overreaction by the bond community and market. Finally, the IRS must be sensitive to the risk of policy-making by audit challenge and the resentment and frustration which that can provoke.

**Policy on Press and Public Statements**

In the past, information about pending audits, whether disclosed formally or otherwise, has resulted in press inquiries to TEB. Frequently, this resulted in a reported IRS response of “I can’t comment on a particular pending matter, but . . . .” The “but” was followed by a brief discussion of TEB concerns as to the substantive problem area raised in the audit. This scenario is troublesome in several respects. First, it obviously raises difficult issues as to confidentiality and the perception of confidentiality. Second, because the reporter is “on the phone now”, it may result in a public statement being made and reported without adequate preparation. Indeed, in an attempt to avoid the earlier mentioned confidentiality issues, the statement may fail to adequately describe a real problem and therefore may suggest a broader area of concern than is actually the case.

The ACT has recommended to TEB that it adopt an internal policy on media contacts and is pleased that TEB has begun to do so. In December, 2005, Acting Director Cliff Gannett required that all TEB-initiated statements to the media be coordinated with and approved by the Manager, Outreach Planning and Review (OPR). In addition, all



incoming media contacts or inquiries are to be referred to the Manager, OPR, who will respond to the inquiry or specifically assign that task. The Manager, OPR is to coordinate media contacts with an assigned Media Relations liaison.

In addition to these procedural steps, the ACT recommends that TEB develop a matrix which will guide the substance of its public statements both to the media and to the various industry groups to which presentations are made. TEB should have a policy as to what is and is not an appropriate response to inquiries prompted by particular audits and controversies. TEB also should have a carefully developed plan as to how it will provide more general comment on new audit initiatives and the results of on-going and completed ones. This should involve more detailed discussion as to targeted-audit problem areas to assist those who are planning transactions and to eliminate market distortions. At the same time, it should be sensitive to the possibility of premature market effects and over-reaction to discussions of audit initiatives which are of an information-gathering nature only.

### **The Provision of Soft Guidance**

As noted earlier, prior ACT reports have described the importance of sharing with the bond community information gleaned from the audit program as to compliance errors. This process was referred to in the 2004 ACT report as “soft guidance.” The current ACT continues to urge that such information be shared with the bond community. However, for that process to be most effective, the IRS must be sensitive to perceptions in the bond community as to its use of the audit process.

Based upon discussions between ACT members and various constituencies in the bond community, it is clear that there is a strong desire for more and better information about problem areas. However, the ACT notes the existence of a parallel theme, involving concern that increased opportunities for TEB communications to the bond community should not result in an expansion of what is perceived to be a trend toward policy-making by audit challenge. The high standard applied to tax-exempt bond opinions, the procedural difficulty and resulting rarity of litigation contesting an IRS challenge, and the “all or nothing” nature of a challenge to the tax-exemption together cause IRS adverse positions to have special weight in the tax-exempt bond area. Some members of the bond community surveyed by the ACT therefore expressed strong ambivalence as to any proposal for increased TEB communication.

Those who feel most strongly about this issue assert that issuers, and their counsel, deserve to have been on notice by way of formal written guidance as to a problem area before being challenged on audit. They assert that legal interpretations and policy should come from Treasury and the Office of Chief Counsel, not from the enforcement arm, TEB. TEB does not deny the validity of that formal allocation of responsibility. However, it notes that the audit process is designed to identify problems where they exist and that, particularly in an area where there is limited formal guidance, it cannot ignore perceived problems which arise on audit whenever they are not yet covered by formal guidance.

The ACT agrees that the TEB audit program cannot be limited to matters which are already the subject of published guidance. However, TEB should take steps to minimize the perception that it uses the audit process to make legal and policy determinations or that it too readily challenges the tax-exemption of audited bonds.

First, in light of the special respect to be given the sovereign state, local and tribal government entities which issue tax-exempt bonds, or on behalf of which they are issued, and in light of the fact that any adverse tax impact will fall on bondholders who are only passive participants in the transaction, TEB must be particularly sensitive to the implications of an audit challenge. It should strongly resist sending to agents in the field the message that a “No Change” audit is a failed audit.<sup>26</sup>

Second, the formulation of new audit initiatives should be undertaken in consultation with the Office of Chief Counsel.

Third, while TEB now has the expertise to no longer need to consult with Chief Counsel in every audit, as had originally been required, it should make greater use of requests for Technical Advice when there is doubt as to legal questions. In addition, TEB should be open to requests by audited issuers that Technical Advice be sought.

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<sup>26</sup> The ACT supports TEB's strong response to certain implied criticism in this regard in a recent Inspector General Report:

TEB's aim, of course, is a compliant Tax Exempt Bond sector. In this regard, we believe that some statements in the [Inspector General's] report — those that seem to equate success in compliance with dollars assessed — are misdirected and incomplete.

Memorandum from Steven T. Miller, Commissioner, Tax Exempt and Government Entities, dated September 23, 2005, attached as Appendix V to Report of Treasury Inspector General for Tax Administration, “Statistical Portrayal of the Tax Exempt Bonds Office's Enforcement Activities from Fiscal Year 2002 Through Fiscal Year 2004” (September, 2005), Ref. No. 2005-10-186.

## **CONCLUSION**

In the course of little more than a decade, the IRS has created a vigorous audit program with respect to tax-exempt bonds which has heightened awareness in the bond community of the need for care to ensure compliance with tax law rules of increasing complexity. This report of the 2006 ACT attempts to ensure that the IRS' audit program promotes voluntary compliance through the timely, accurate dissemination of information about audits and the audit program and that it does so in a manner which avoids disruption of state, local and tribal government activity or the bond market.

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